The Ghost In The Machine

July 2015

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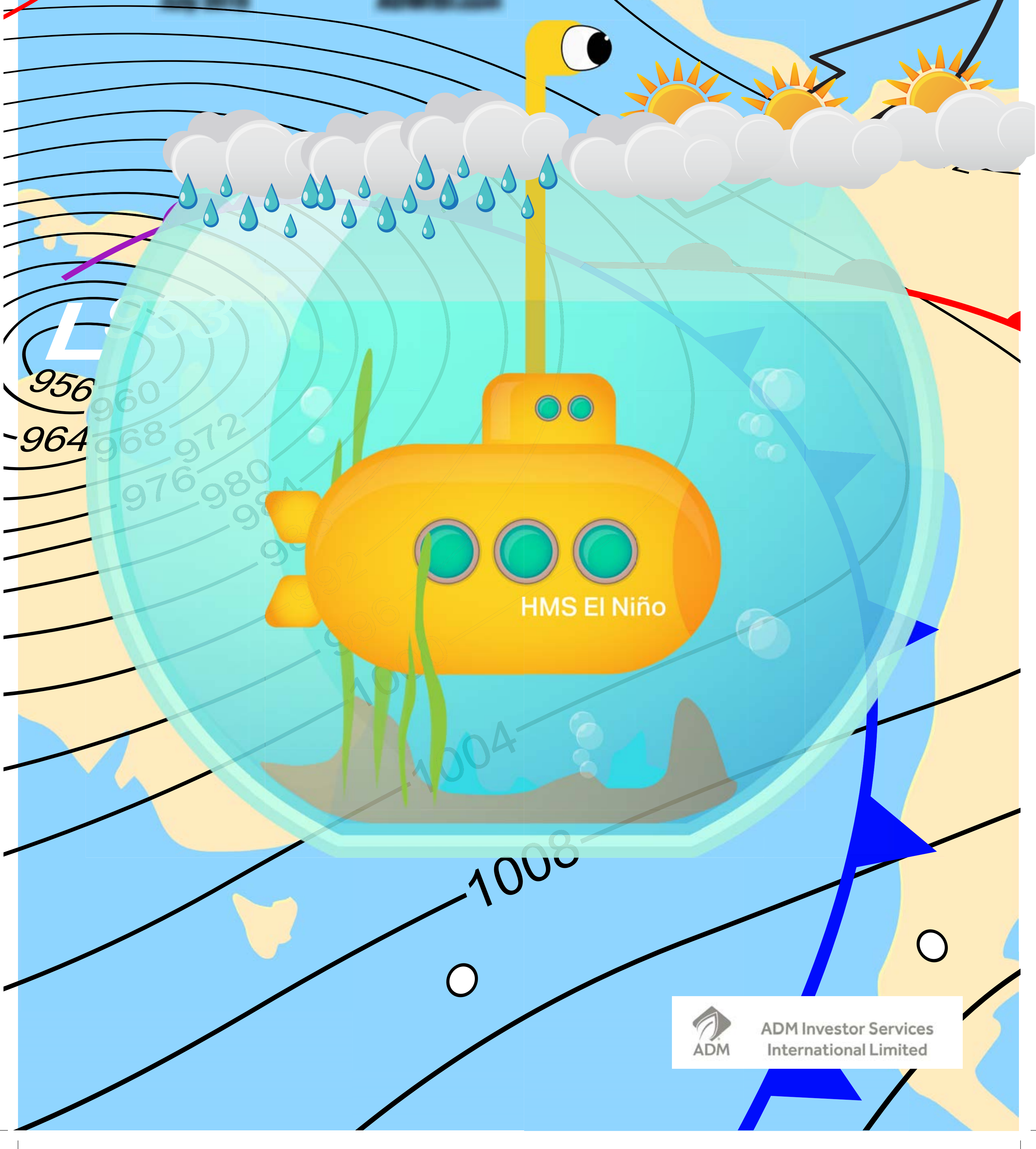

ADM Investor Services International Limited

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Editor's Note
June 2015

Editor's Note

Welcome to the July edition of

The Ghost in the Machine

Welcome to the third 'The Ghost In The Machine' and we hope that you enjoy the mixture of insight and actionable ideas.

The principal theme, which

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Indian Modi-fication

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"We mould clay into a pot, but it is the emptiness inside that makes the vessel useful." Lao Tse - Tao Te Ching (literal translation: "Way To Heaven")

It was the economist Albert Hirschman who articulated the principle of the "Hiding Hand", as a counter to the hegemony of neo-classical economics' adherence to Adam Smith's "Invisible Hand" - the principle that "the general welfare is best served by everyone catering to his private interests, legitimating total absorption of the citizens in their own affairs". Hirschman above all challenged the latter's over-simplification of human behaviour into a set of axioms steeped in 'laissez-faire' and 'rational choice' dogma. In contrast to Schumpeter's concept of 'creative destruction', Hirschman's 'Hiding Hand' argues that creativity is the key problem-solving tool when we face unexpected situations; and that it is only via the experience of impotence when faced with the unexpected that we develop the innovative knowledge to solve problems, and that 'rational choice' often stifles innovation and creativity.

As financial market participants fret about the outlook for the global economy, above all the perceived threat of 'secular stagnation' in developed economies, as well as a sharp and protracted slowdown in China, policymakers (the world over) might be well advised to revisit some of Hirschman's ideas; above all his work in developmental economics. Hirschman stressed the need to understand local structures and resources prior to any intervention, and to eschew formulaic World Bank criteria, assumptions and models. He also emphasized the need for 'latitude' in planning and directing projects, on the basis that rigid project structures and procedures stifle managers' creativity and indeed their confidence, and more than likely lead to the exclusion of solutions and products, which may perhaps be 'no less desirable, and far more feasible, than some other' (Hirschman, 'Latitudes and Disciplines' 1967). He also noted that prescribed assumptions about how and when projects are initialized and implemented can in fact foster corruption, though he also advocated applying some latitude in dealing with corruption, in so far as completely eradicating corruption leads to stagnation, instead of encouraging countries to face up to and learn to deal with such problems.

Last but not least Hirschman also outlined the concept of 'possibilism', which is an approach to escaping 'straitjacketing concepts' such as perceived 'absolute obstacles', imaginary dilemmas and one-way sequences", noting that such "obstacles" can often turn out to be an asset or, at the very least, a spur for change. Hirschman also argued that such 'inverted sequences' should not be seen as having primacy over 'orderly sequences', but rather as a means to 'increase the number of ways in which the occurrence of change can be visualized'.

Hirschman's ideas are useful when considering some of the challenges that China faces in adapting its economy after three decades of very rapid growth, particularly, as it simultaneously tussles with the US for hegemony of the global economy (see also: Stephen Lewis's May 21 2015 Economic Insights "China challenges world order"). China's current growth 'challenges' can plausibly be construed as being due to the confluence of a very disparate set of factors. Under a Hirschman style analysis, there was always going to be a point at which the policy parameters that underpinned China's rapid expansion would reach an asymptotic level, where the impulses for the economy were outflanked by increasing institutional rigidities, which fostered ever greater imbalances, while rising bureaucracy, corruption and malpractice stifled creativity and risk-taking. It can certainly be argued that the Chinese authorities' massive 2009 credit-driven stimulus to counter the impact of the global financial crisis was a fairly logical though flawed response, even if it had the ostensible objective of maintaining the broad parameters of its 'investment-led growth' strategy. Nevertheless it saddled local (municipal) governments with huge debts, and perhaps most significantly gave the financial sector a much greater prominence in the economy than its previous role of "oiling the wheels of the real economy largely at the behest of the Chinese authorities". It also helped to spawn rapid growth in the shadow banking sector. The latter was equally a function of the system of artificially low deposit rates which has heretofore existed in China.

It can also be argued that the huge credit-driven stimulus was always going to upset the balance of an economy, where the liability side of the country's balance sheet had been largely functionally irrelevant, above all due to the colossal scale of the wealth and assets, which were amassed during the benign period of globalization in the world economy. The fact that China's total debt to GDP ratio has leapt from some 150% in 2008 to the current 282% has very sharply heightened the probability of some form of debt crisis, and the three defaults over the past year only serve to add to such concerns. Nevertheless, such statistical representations are rather more cannon fodder for headline writers. The more pertinent aspects are the context of how this "credit bubble" has evolved, how bad debts are resolved, as well as the more complex aspect of the extent and the form of the liability structures that have attended this explosive debt growth, specifically in terms of what potential there is for the type of chain reactions and so-called 'balance sheet inversions', seen in the 2007-2008 financial crisis. From a Hirschman-style perspective, above all in terms of inverted sequences and possibilism, China's current debt woes could prove to be a form of 'hiding hand' trigger for China to transform its financial sector, and its nascent securities markets (the stock market being just 25 years old). In turn, this may well help in the formation of less opaque and more open capital markets that would be commensurate with the longer-term objectives of establishing the CNY as a reserve currency, rather than it largely being a payment vehicle for trade, and thus gradually opening China's capital account, in terms of both inflows and outflows. It is critical in any analysis of how China might evolve its economy and financial sector that, as outside observers of China's economy, our perspective is not encumbered by the aforementioned "obstacles" and "one way sequences", by prejudging as Hirschman observed "the extent, much less the modality, of the wider social and political transformations that may or may not be a prerequisite for" reforms.

Bearing in mind the need to jettison our "cultural baggage", the decision by China's National Development and Reform Commission to allow local governments to sell debt publicly is very significant in a number of respects. Of the total current outstanding debt of China's municipalities, which stood at CNY 17.9 Trln according to the most recent (2013) official statistics (and may be as high as CNY 25.0 Trln now, according to some private sector estimates), just over half is accounted for by banks and trust companies. If the long-term objective is to transform the vast majority of this debt into bonds, this would create a municipal bond market of CNY 10.0 Trln (ca. $1.6 Trln) or more, which would be the second largest after the US. The benefits of creating such a market are multifaceted. Initially it will dramatically reduce debt servicing costs for local governments, in so far as their existing funding vehicles often pay rates of 10% or more on loans from banks and trusts, and by contrast longer-dated municipal bonds should price with a small (ca. 0.50% to 0.75%) premium over government bonds, which currently yield 3.5-4.0%. As importantly, as China seeks to reform and liberalize its interest rate markets, it should facilitate the pricing of credit risk, create far greater transparency about, as well as imposing considerable discipline on, local government finances. That said, it will also require the State Council to offer rather more autonomy to local governments in terms of their options for generating revenues. Of course, banks and trusts will be sacrificing considerable interest income in return for being relieved of some of the burden of financing local governments, though they would also be in a better position to provide more credit to the private sector. But there should be considerable benefits by way of reducing the use of the existing loans in less than desirable, often leveraged, "reach for yield" schemes and structures in the shadow banking sector. Given that the main buyers of the municipal debt would be the state-owned "policy" banks (like China Development Bank) along with commercial banks, it should assist in evolving the PBOC's repo operations into a better functioning mechanism for managing liquidity. Naturally, sceptics argue that such a major transformation of local government debt is in effect a form of QE, perhaps even debt monetization, and that it highlights very poor underlying governance practices and principles.

While such criticisms are justified, a Hirschman-esque perspective might counter with the following points. A cornerstone of the USA's economic success has been addressing crises decisively, quickly and often ferociously, in stark contrast to much of Europe, as the Eurozone crisis has amply demonstrated. Secondly, China is a top-down command economy, therefore central and local government are in principle one and the same, and local governments are per se the executors and the fiscal agents of central government policy. At this critical juncture, where its previous domestic investment and export demand-led policies are no longer viable, both from a domestic and global perspective, mitigating and purging the fall-out from previous excesses makes common sense, particularly if it were to instil better discipline and purge malpractice at a local level. The fact that the recent PBOC rate cuts have been accompanied by tentative steps to change the way that banks are allowed to set deposit rates relative to official PBOC rates, underlined further by the very recent changes to the rules on transfers of large scale Certificates of Deposits (CDs), confirms a determination to progress with reforms and some liberalization of the financial system, about which most observers have been very sceptical, both in terms of its scale and extent.

But, as is widely recognized, it is how productively the asset side of an economic entity (country or company) is managed, which will determine its growth trajectory. In China's case, the focus is primarily on how it redeploys its spending and its savings. As has become clear over the past five years, pumping ever more money into productive capacity will not work, and will hamper the process of purging overcapacity in the sectors which are set to play a much smaller role in the economy going forward, as well as making no sense in terms of addressing a vast array of environmental problems. Equally the accumulation of vast quantities of FX reserves is counterproductive in the context of the current shift in capital flows, and more importantly the intention to gradually open its capital account. Escaping those shackles of a purely political perspective, it makes more than a lot of sense from the theoretical and practical aspect of managing its asset more productively, for China to look to the sort of relatively recent initiatives – be that the "New Silk Road" or One Belt, One Road (OBOR) plan, the BRICS Development Bank or the AIIB (Asia Infrastructure Investment Bank). If China is to gradually open up its Capital Account, not only with a view to the CNY's inclusion in SDRs and by extension its deployment as a reserve account, then it must strengthen and diversify its foreign asset base far beyond an accumulation of FX reserves, and a series of claims on foreign countries that are primarily focused on securing primary resources. Above it all needs to invest in real sector assets, not only to generate income that is not primarily based on the trade of goods, but also to facilitate investment and business opportunities for local companies (financial and non-financial). The fact that Asia has been estimated to have infrastructure investment needs (per se a deficit or shortfall) in excess of US$8.0 Trln only emphasizes the opportunities.

Understandably, the external suspicion is that this is a means to expand China's sphere of influence, which goes well beyond the purely economic. Still, one might counter with the following question: how would one want China to deploy its assets? Is it preferable for it to continue to deploy the China Development Bank, which operates purely under domestic supervision and governance, or via the BRICS Development Bank, whose capital base looks operationally rather shaky, and whose governance may be questionable. Or is the AIIB preferable, given that 57 nations are stakeholders, many of them developed world nations, and thus have a major stake in ensuring the AIIB has a suitable governance structure, and is appropriately monitored and supervised. To be sure, none of China's transformational plans are either a panacea or indeed guaranteed to be successful. Nor should we be anything but sceptical and critical of Chinese governance in many spheres (social, environmental and economic), or indeed, about the quality of data and information that is produced by its authorities, but that does not by any stretch of the imagination imply that its current plans will not reap many benefits both for China and for the rest of the world economy.

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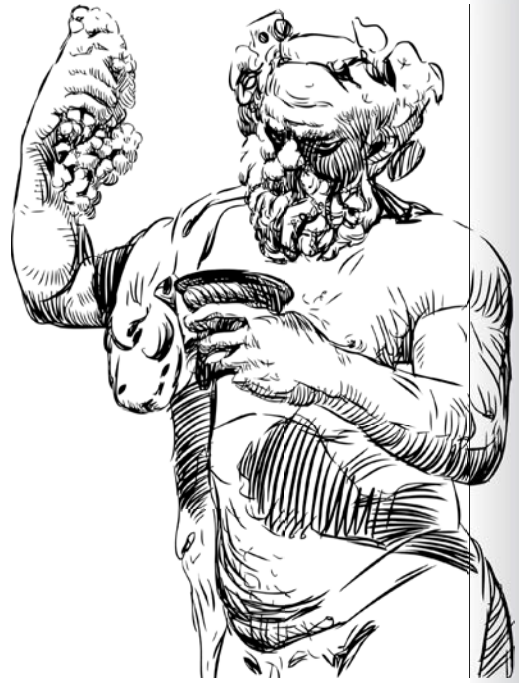

SIGNAL AND NOISE

It was Ben Bernanke who drew attention to the seasonality in US economic figures. In Congressional testimony on 7 June 2012, he judged a US business slowdown, as reflected in data during the early spring of that year, as exaggerated 'by issues related to seasonal adjustment and the unusually warm weather this past winter'. His idea was that applying standard seasonal adjustments to raw data during a mild winter led to over-estimating growth during the winter months, but under-estimating it during the spring.
Mr Bernanke had identified a classic instance in which difficulties of seasonal adjustment gave rise to a misleading signal. In 2013, after US data again weakened during the early months of the year, he commented, 'there has been a certain tendency for a spring slump that we have seen a few times. One possible explanation for that, besides some freaky things, some weather events and so on, one possible explanation is seasonality.'

Problems with seasonal adjustment are not only related to variability in the weather. Mervyn King famously used to say it was unwise to judge the strength of Christmas spending before the following Easter. This was because patterns of price discounting around the winter holiday season differ from year to year.

These general observations are relevant when judging recent US economic statistics. The advance report on US real GDP in 2015Q1 pegged annualised growth from the previous quarter at a negligible 0.2%. This GDP number seemed to corroborate other statistics, such as March non-farm payrolls, indicating a slowdown in the US economy since the beginning of the year. However, while GDP appears to have come to a virtual full stop in this narrative, the situation would look different if growth comparisons were made in year-on-year terms. The quarterly progression of real GDP growth rates would then run from 2.6% in 2014Q2 to 2.7% in Q3, 2.4% in Q4 and 3.0% in 2015Q1. Year-on-year growth in the first quarter of this year was the fastest since 2013Q4. Far from showing weakness in the latest published quarter, US GDP, in fact, more than maintained its recent pace of growth. The objection to this line of argument is that the base in 2014 from which 2015Q1's year-on-year growth is measured was unduly depressed by severe weather as the 'polar vortex' took its toll. But winter weather was disruptive this year also. Additionally, income tax refunds in March were some $5bn lower this year than last. There was further dislocation of US economic activity early this year from the West Coast port strike. Consequently, the first-quarter growth data, seen in the round, are open to a positive interpretation.

That may well be how a majority of FOMC members choose to see the situation. They are likely to take comfort from the rebound in payrolls growth in April. The monthly 223k increase in jobs was close to the 248k average for the latest twelve months and included, consistent with the improved weather, a 45k recovery in construction employment. Still, the FOMC need not reach a verdict on the state of the labour market at this point. There will be another set of monthly data before the committee next meets on 16-17 June.

In the meantime, members will probably hope to see signs of a pick-up in consumer spending. While special factors may explain recent sluggishness, these excuses will lose their credibility if spending does not accelerate soon. Further, business inventories have been climbing recently. The latest figures, for March, recorded an inventory-to-sales ratio of 1.36, compared with 1.30 in March 2014. It seems plausible that this high level will not be sustained.

The implications of an inventory unwind for US economic growth are hard to determine. Often, in such circumstances, rising inventory levels have reflected weak final sales. Because of sharply falling prices for some goods, it is difficult to say whether nominal sales, admittedly weak, also reflect unduly soft sales volumes. Then again, inventories may have been deliberately increased in anticipation of port strike disruption to imports. To the extent this was the case, the unwinding of the inventory position will find a counterpart in weaker imports, with the net effect on US GDP being neutral. There would be a similar result with respect to GDP if the inventory growth reflects finished goods for export that were locked in by the strike. The release of these exports would then offset the fall in inventories in its effects on GDP. More information is needed but there is still a month's worth of economic data to be released before the FOMC has to make an assessment.

In any case, some FOMC members appear to be taking a much broader-brush approach to the data than financial markets generally suppose. Mr Williams, San Francisco Fed president, shed light on what is probably the dominant FOMC view in a speech on 12 May. He pointed out the Fed had set two markers for raising interest rates. They were that it should be 'reasonably confident' inflation would rise to its 2% target and that the labour market should continue to improve. His view was that the Fed's baseline forecasts satisfied those conditions and would, if matched by outcomes, justify a tighter Fed monetary stance. It should be noted that economic growth is not one of the FOMC's markers. Growth depends to a large extent on productivity, which is not susceptible to Fed policy measures. Mr Williams used to be chief economist of the San Francisco Fed when Ms Yellen was its president. His views are reckoned usually to be very close to hers. That is why his comments on policy deserve careful attention.

Mr Williams favours an early start to rate-hiking. This is because he is concerned the Fed should not have to make any sharp moves once it begins to tighten. If the FOMC were to wait until the 'output gap' had closed, with full employment and inflation already at the target rate, it might then have to take vigorous action to forestall a serious inflation overshoot. That action could be seriously destabilising for financial markets.

That is not to say the Fed will, in fact, be able to initiate a tightening move without upsetting the markets' balance. However cautious the steps the Fed takes, there have been plenty of indications global capital markets are no longer resilient in the face of even small changes in the fundamental and policy background. What may well disturb officials is not the scale of such recent market moves as the one-day decline in US Treasuries last October and the Bund-driven break in global bond prices earlier this month. It is rather the thin market trading that preceded and accompanied the moves. FOMC members are likely to conclude that 'normalising' monetary policy is going to be a tricky operation. That is the rationale for starting soon and going gently.

If capital markets do react badly to the Fed's initial tightening, some investors may hope the central bank will promptly reverse its action from fear of potential damage to the economy. However, a flip-flop on policy at such a critical juncture would be unlikely to appeal to FOMC members as a credible policy-response. It would lead straight into a scenario where markets believed the Fed was unable ever to 'normalise'. Mr Bernanke probably never dreamed that 'normalisation' would call for so delicate a touch. He always maintained that it would be straightforward but it is his successor who faces a real challenge.

Global Metals Comment

METALS STOCK FLOW, RAINS ON LME PARADE!

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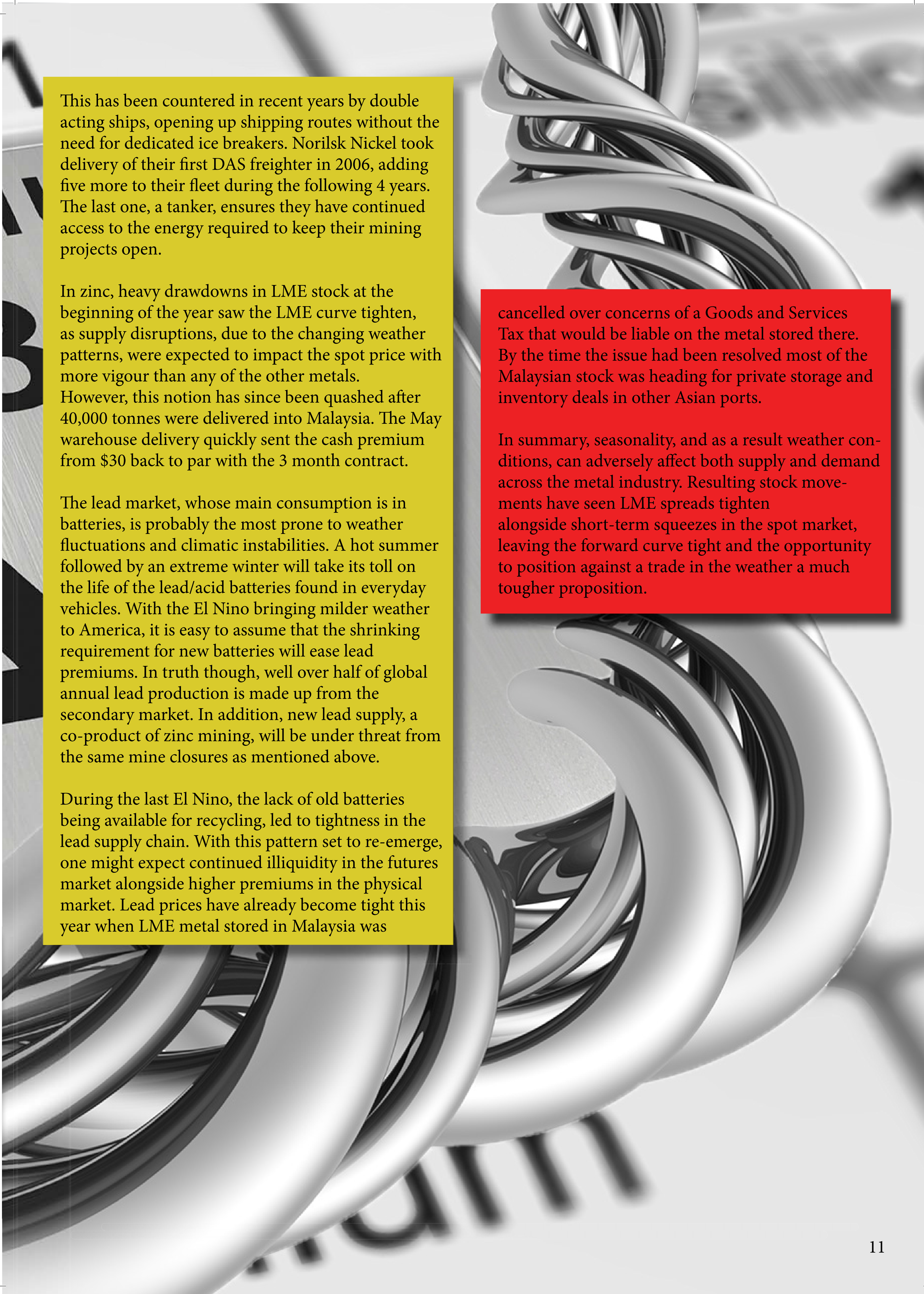
Confirmation of the strengthening El Nino in early April has raised price concerns in agricultural commodities; with the prices of cocoa, coffee, palm oil, rice, sugar and wheat all about to be affected.

As water temperatures rise in the Pacific Ocean, shifting wind patterns across the Pacific Ocean, the El Nino brings drought to Australia and heavy rains to South America, in turn wreaking havoc on commodities prices.

However, El Nino's conditions do not automatically push prices up and early speculation to that effect may prove costly as the strength and length of the El Nino weather system plays out. Occurring every few years with a differing impact on soft and agricultural commodity prices, El Nino is usually less likely to be associated with changes in metal prices.

Nonetheless, this year has already seen heavy rains in South America force the closure of several copper mines and, albeit short term, transport routes, shipment and mining activity were all affected by the deluge. The rains in April came at a time when the metals market was set for further decline, already under pressure from the sharp move down in the oil markets and falling confidence in Chinese demand. The ensuing mine closures brought a much needed relief to the London copper bulls, who had been locked in a battle with the Chinese bears as the copper price had seen aggressive selling from 6400 down to 5400 in the previous weeks.

It is not just the El Nino phenomenon that affects metal production and supply. In the nickel market ice floes in the Baltic can impair shipping links in and out of Russia during early spring, squeezing premiums in both the LME spot price and physical market.



This has been countered in recent years by double acting ships, opening up shipping routes without the need for dedicated ice breakers. Norilsk Nickel took delivery of their first DAS freighter in 2006, adding five more to their fleet during the following 4 years. The last one, a tanker, ensures they have continued access to the energy required to keep their mining projects open.

In zinc, heavy drawdowns in LME stock at the beginning of the year saw the LME curve tighten, as supply disruptions, due to the changing weather patterns, were expected to impact the spot price with more vigour than any of the other metals. However, this notion has since been quashed after 40,000 tonnes were delivered into Malaysia. The May warehouse delivery quickly sent the cash premium from $30 back to par with the 3 month contract.

The lead market, whose main consumption is in batteries, is probably the most prone to weather fluctuations and climatic instabilities. A hot summer followed by an extreme winter will take its toll on the life of the lead/acid batteries found in everyday vehicles. With the El Nino bringing milder weather to America, it is easy to assume that the shrinking requirement for new batteries will ease lead premiums. In truth though, well over half of global annual lead production is made up from the secondary market. In addition, new lead supply, a co-product of zinc mining, will be under threat from the same mine closures as mentioned above.

During the last El Nino, the lack of old batteries being available for recycling, led to tightness in the lead supply chain. With this pattern set to re-emerge, one might expect continued illiquidity in the futures market alongside higher premiums in the physical market. Lead prices have already become tight this year when LME metal stored in Malaysia was cancelled over concerns of a Goods and Services Tax that would be liable on the metal stored there. By the time the issue had been resolved most of the Malaysian stock was heading for private storage and inventory deals in other Asian ports.

In summary, seasonality, and as a result weather conditions, can adversely affect both supply and demand across the metal industry. Resulting stock movements have seen LME spreads tighten alongside short-term squeezes in the spot market, leaving the forward curve tight and the opportunity to position against a trade in the weather a much tougher proposition.

COFFEE in the MIX

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BEAN HERE BEFORE

Looking back over the month of May 2015 and to the day of writing Arabica coffee has staged a small recovery after managing a new July 2015 year low of 123.55 (contract low 121.15) on 27th May with the high on 19th of 143.85 looking like all but a distant memory. A 20 cent decline in less than seven trading sessions even for coffee is quite a fall! The failed rally and long liquidation seen from these highs met with little support until we retraced back towards the 132 area on July and the Industry forward buying. At this lower level it was Origin and fresh fund selling forcing values through the 128 area enticing further mixed fund long liquidation and fresh shorts, total OI up over 10k lots to circa 195k lots.

NY Arabica Coffee

Source: REUTERS

Into late May and a possible bottoming as selling abated, maybe waiting for the month end COT, the question now being 120 or 130 as we move into a new month and the last in Q2. This month too we have had USDA numbers suggesting a Brazilian crop of 52.4 mln bags for 2015/16 with carryover stocks of 4.29 mln bags, higher than some expected, with other trade houses adjusting their numbers higher and with physical business remaining subdued. So the Arabica bear camp see better supplies than maybe initially thought and for the moment the want for fresh coffee less. Funds are

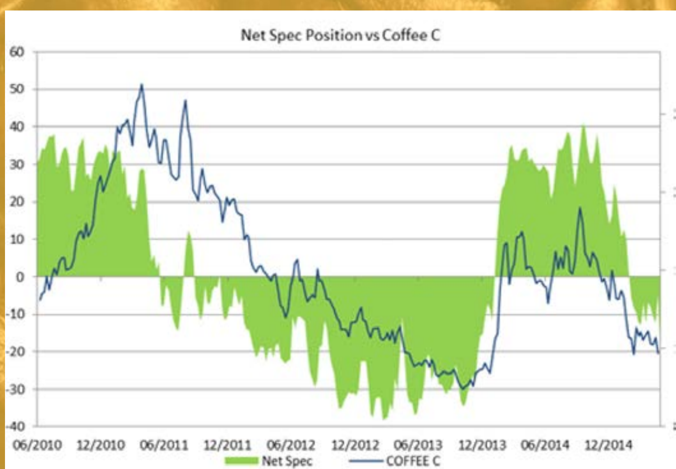
London Robusta Coffee

Source: REUTERS

now holding over 50k lots of a gross short position, a significant factor in the small recovery we have seen on the first trading day of June. Looking at the graph overleaf, however, a net spec short position of 21k is still some-way off the record lows seen in 2013. The bulls continue to hold a fair 33k lot long position, fairly unchanged in May and remain committed to their cause. As we move into the summer season, for the bulls of commodities we have talk of El Nino that could create adverse weather conditions globally and get people looking back at the charts of 2010. As we approach the Brazilian winter however, the inevitable stories of frost will linger in the minds of the seasoned coffee traders and that sizable short position will look vulnerable to any scare.

The Robusta market stays fundamentally quiet and is really only trading off the back of the NY moves. Most talk centres around the Vietnam producer sell stops that lurk somewhere beneath current lows below $1600mt. With the Vietnamese well sold on consignment but with a large amount unfixed, the trade houses will be unforgiving if we reach sell stop levels for these exporters.

NY Arabica Coffee



Source: US Commodity Futures Trading Commission

Towards the end of last week however, confidence did build as exporters put up cash to buy them some more time and move their stops lower. Physical business in Robusta again remains quiet as replacement differentials are substantial above industry buying ideas.

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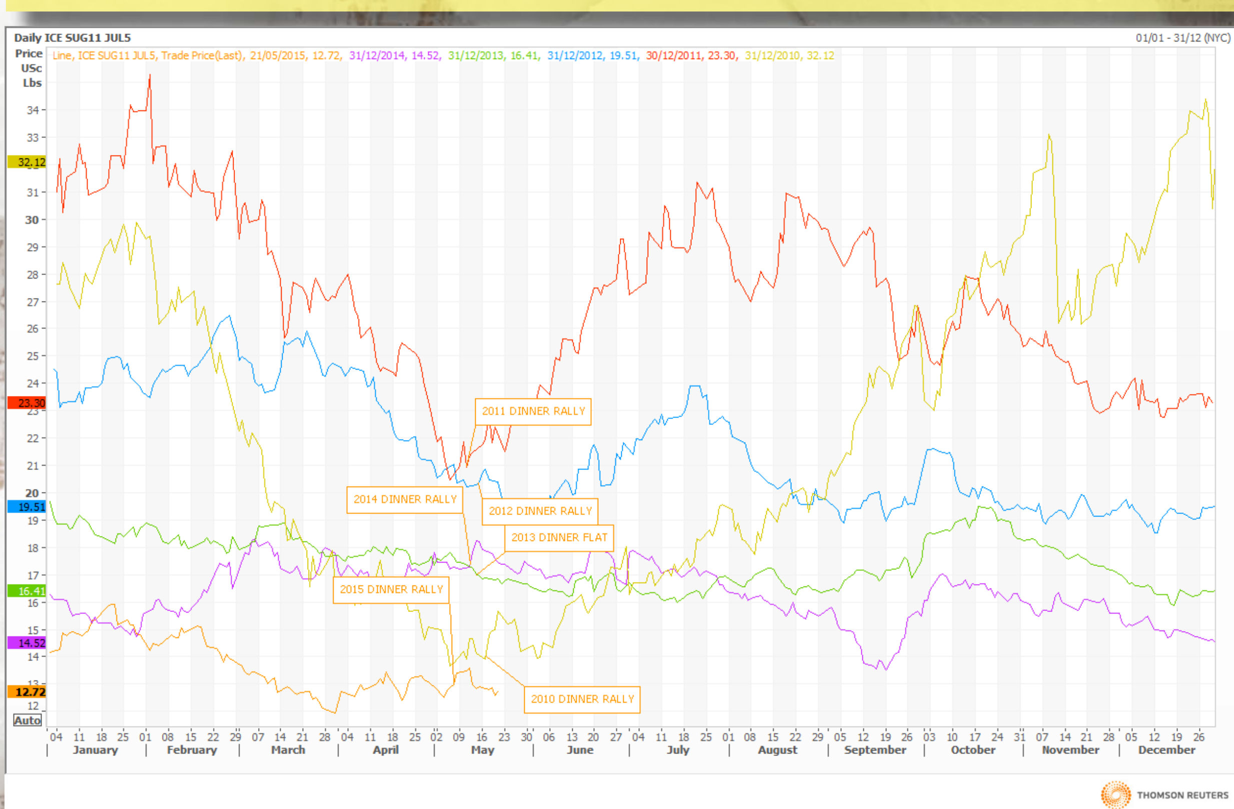
Seasonal rally in sugar?

The second week of May sees the good and great of the sugar industry gather in New York for the annual dinner. Historically there is frequently a rally in prices several days before the dinner, only for values to retrace gains shortly before traders sit down at the Waldorf Astoria hotel. Initial bullish enthusiasm from traders attending early functions soon give way to reality as analysts, and often logic, turn the sentiment bearish. One could argue that this short-term trend has become self-fulfilling over the years.

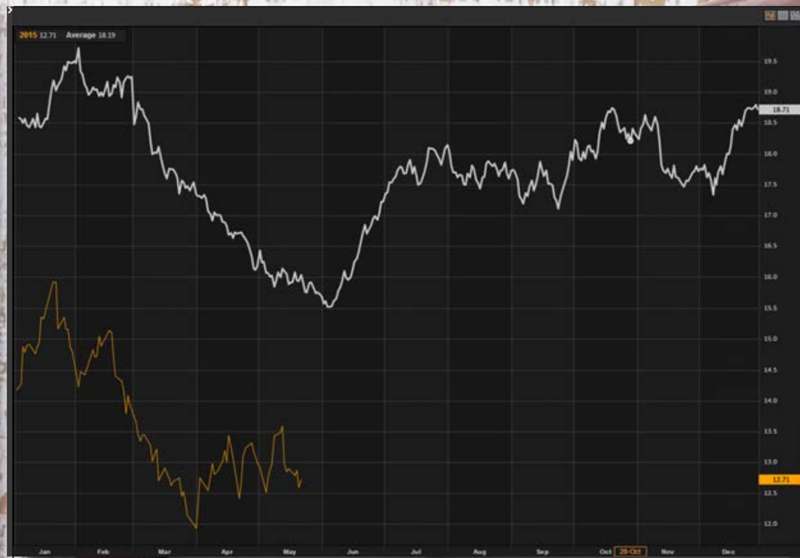


Is this the case for more long-term seasonality trends seen in sugar? The seasonality chart (over past 10 years) shows some distinct patterns. It should be noted that the 30-year seasonality chart shows very similar patterns.

The New Year often starts with a mid-January rally as some scare story or other (often weather related) appears in print and grabs traders' imagination (often without much foundation). One could add the Dubai sugar conference helps fuel these stories!!

Generally the euphoria is short-lived with prices starting a more pronounced slide late February. Producer selling appears as the harvests from Brazil's Centre South, India, Thailand and China slowly build up to peak harvest which often coincides with prices hitting their lowest level for the year – usually around end of May/beginning of June. This weakness often sees the structure of the board go to contango (cash and carry) allowing traders to roll physical sugar from these large harvests forward with little cost.

A recovery in prices is typically seen through to July as the producer selling dries up and end-destination often gets caught under-priced. Add in a few end-of-harvest scare stories and prices often recover over 80% of their February value.The summer holiday season usually sees prices settle into a relatively narrow trading range until we get into the last quarter of the year when prices often improve slightly as traders argue the finishing size of the Brazilian sugar production only to see a pre-holiday sell-off in first half December.

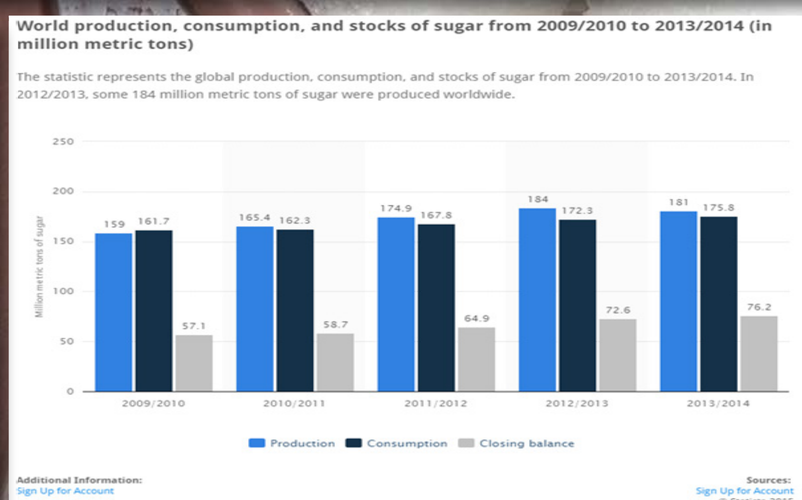


Therefore, the most pronounced seasonal move is the spring slide and subsequent partial recovery. While there are certain trends during the rest of the year, they are open to conjecture as to their causes and it is probably not wise to use them in making trading decisions.

This year prices have dropped from 16.16 in mid-January to their current level of 12.70 thereby maintaining the historic seasonal trend. So, as we come to the end of May, will 2015 represent a buy as it responds to type, or buck the long-term trend with prices continuing to remain weak? There is definitely an element of self-fulfilment. While funds and speculators may not want to go long, they are likely to cover shorts in anticipation of the seasonal rally. (It should be noted that the funds have cut their record net short position of over 113k as of early April to long of 215 lots as of 12 May.)

Fundamentals remain resolutely bearish with little reason for prices to improve.
Sugar production is likely to outstrip demand again this season – the 5th season in a row. However, meteorologists are predicting the development of an 'El Nino' phenomenon by the 4th quarter this year.

They said similar last year but it turned out to be a false alarm. This time they appear a lot more confident but whether it grabs the attention of the funds remains to be seen. They seem more obsessed with the strength of the US dollar at the moment. Will the old adage "The trend is your friend" prevail? Difficult to argue otherwise.



Equities Are Awesome

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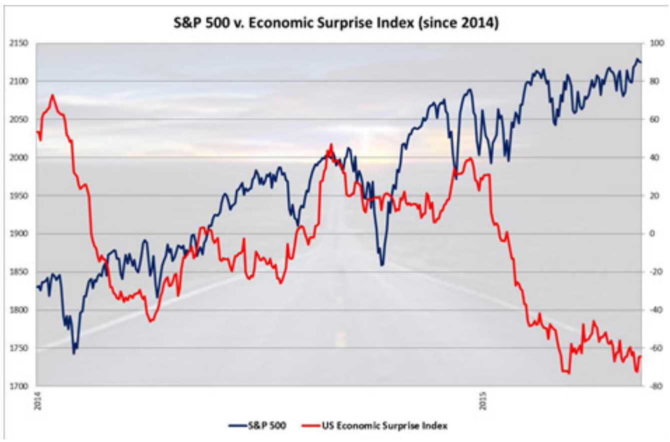
Equity Markets "Banking" on Reflation

Equity markets are becoming increasingly dislocated from economic trends, especially the US…



Source: Bloomberg, ADMISI

…and China.

Source: Bloomberg, ADMISI

There are even emerging signs of the same thing in the Eurozone.

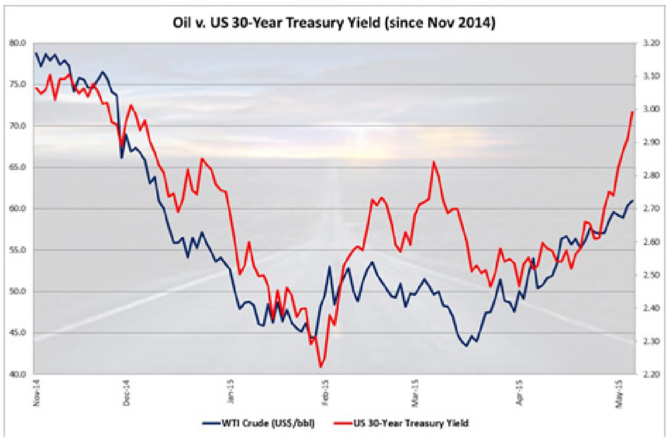
Source: Bloomberg, ADMISI

The recent turmoil in the bond market followed the more "dovish" than expected FOMC meeting on 18 March 2015 when the FOMC indicated that it might back down from a June rate hike. This provided a "relief valve" on the growing deflationary panic of tightening dollar liquidity, declining bond yields (especially in Europe) and expectations that crude oil could fall to US$30/bl.

The signal from the FOMC took the steam out of the dollar's rise and eased the intense pressure on currencies like the Brazilian Real.

Source: Bloomberg, ADMISI

The subsequent steps in the chain of events were critical. The correction in the dollar eased pressure on the commodity complex, especially crude oil which began to rebound. A rise in the world's most inflation-critical commodity meant that bond yields were probably going to follow suit…and they did.

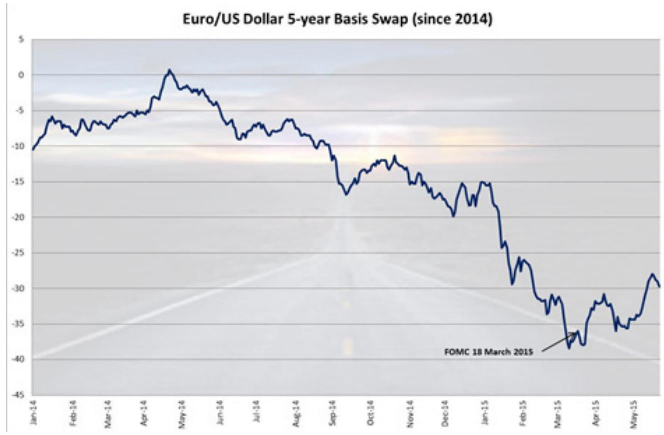


Source: Bloomberg, ADMISI

This has led to a widespread belief that the dollar has peaked, bond yields have bottomed and a reflationary bounce in the global economy is in prospect. Equity markets, especially the S&P 500, seem to be discounting this.

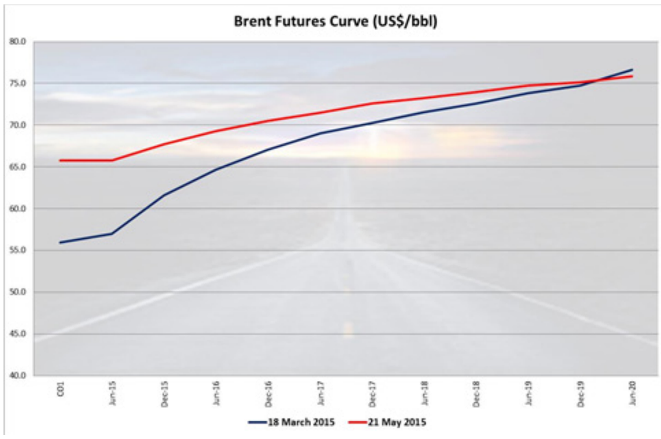
While we are believers in an inflationary endgame, this might be too hasty.

Dollar liquidity remains very tight. A key indicator that we are monitoring closely is the Euro/US dollar 5-year Basis Swap which remains firmly in negative territory and has been since mid-2014 when the dollar bull market began.



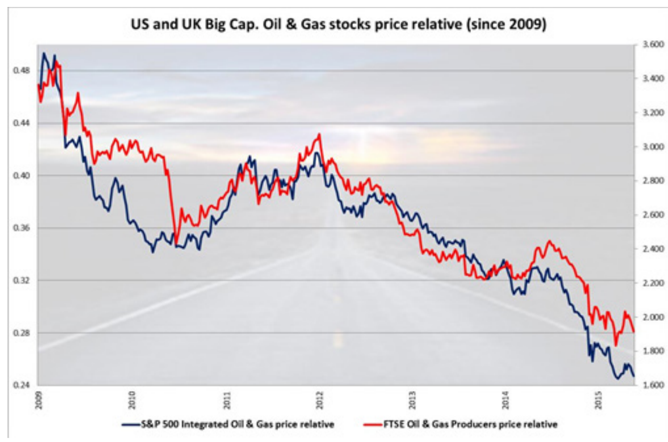
Source: Bloomberg, ADMISI

The rise in the front end of the crude curve hasn't been reflected further out.



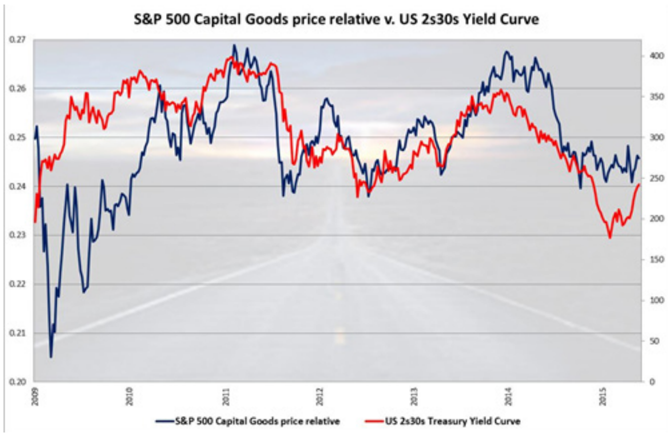
Source: Bloomberg, ADMISI

The modest recovery in the Oil sector's price relative is fading.



Source: Bloomberg, ADMISI

The Capital Goods sector generally outperforms with a rise in US long bond yields. However, it is not "buying" in to the reflation and global growth story in the US…



Source: Bloomberg, ADMISI

…or Europe.

Source: Bloomberg, ADMISI

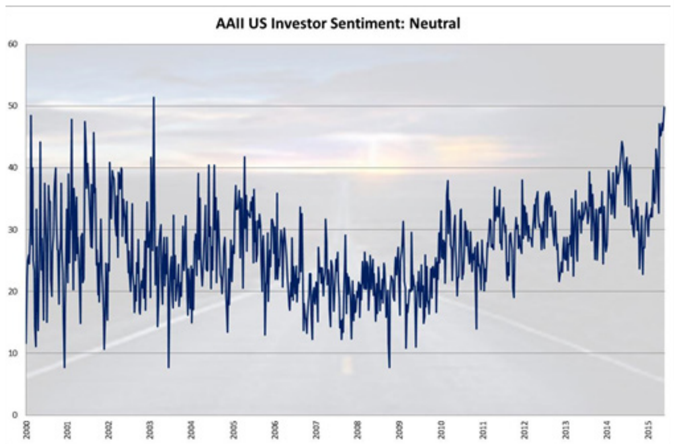
While "real economy" sectors remain sceptical about the reflation narrative, the Banks sector is outperforming as yield curves steepen. Here is the US sector versus the 2s30s Treasury yield curve.

Source: Bloomberg, ADM ISI

And the European banks versus a generic Eurozone yield curve.

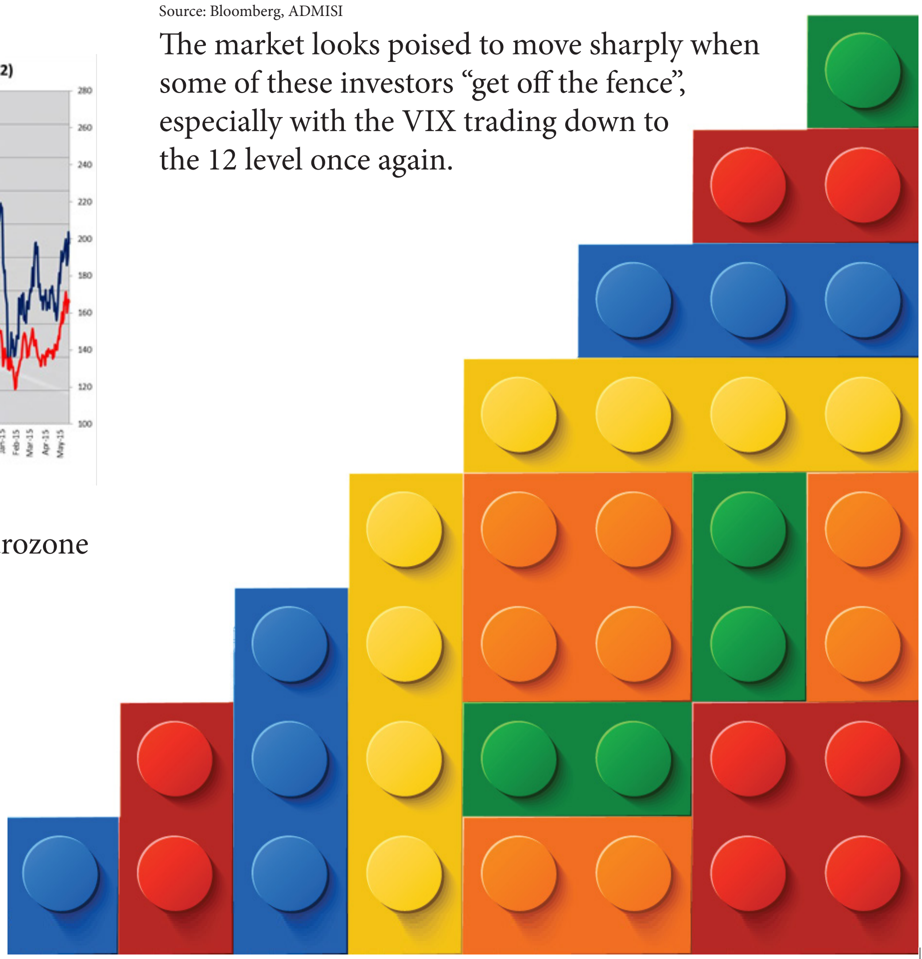
Source: Bloomberg, ADMISI

Either the Deflationary view or the Reflationary view is going to prevail and we tend to side with the former. Meanwhile, US equity investors have become more and more uncertain. The neutral category of investor sentiment is the highest it's been for more than a decade.



Source: Bloomberg, ADMISI

The market looks poised to move sharply when some of these investors "get off the fence", especially with the VIX trading down to the 12 level once again.



View from under a toadstool

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SELL IN MAY AND GO TO DONCASTER RACECOURSE

Doncaster racecourse is not only one of the oldest horse racing venues in Britain but it is also, in terms of capacity, one of the biggest. Apart from those impressive accolades, Doncaster also has the distinction of opening the 'flat' racing season and the famous Town Moor track has the honour of hosting the closing Grade 1 meeting, featuring the world's oldest classic horse race, the St Leger, founded in 1776.

In Trivial Pursuit circles, St Leger might be best known as a revered sixth century archdeacon. To gamblers, it is, no doubt, a venerable horse race, but to equity investors, St Leger's day is one of the most devotional market timing tools; "Sell in May and go away, to not return til St Leger's Day". Not exactly Byronesque in its lyricism but enticingly profitable to compensate.

The bible of these seasonality benefits is the Stock Trader's Almanac and it is an entertaining read. The editor Yale Hirsch (I wonder if he actually went to Yale?), says that if you invested into the US equity market $10,000 in 1950 on 1 November and sold your holdings on 30 April each year, your holding would now be worth $785,000. Whereas, if you had bought $10,000 on 1 May and sold on 31 October, your holding would now be worth, after all those years, a dismally unchanged $10,000.

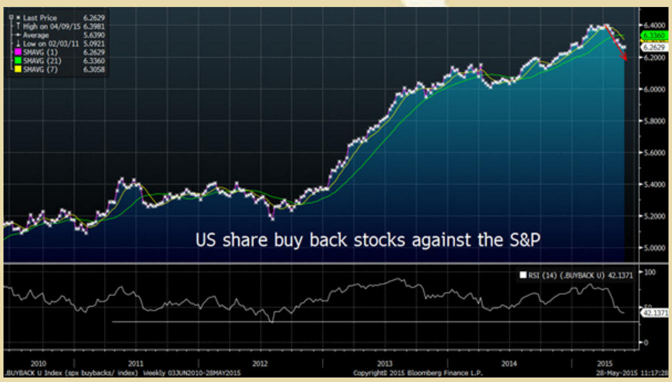
The wonderfully named 'moneychimp.com' gives us data from 1950 to 2012. The month of June, they say, has had 32 up months and 31 down months compared to December, which has had 48 up months and 15 down months. September has had 28 up and 35 down.

More recently, from 1998 to 2012, an investor buying the S&P 500 at the beginning of the year, selling everything on the last day of May (leaving it a bit late on the old adage, albeit that the 20th trading day of May is historically the worst trading day of the year), then buying again on the first day of November and selling on the last day of December, would have made 33.6%, compared to an investor who ran their long, for the entire year, who would have lost 8% !

Of course, the financial crises in the early 2000s and 2008-2009, did emanate during June and October ….but perhaps that is, in itself, discarding the answer to the puzzle, while trying to solve it.

The evidence is compelling and there have been innumerable mathematical studies into seasonality, across the ages, but mathematics tends to overlook the psychology and focus on the rational; a dangerous investment trait. Ironically, the first guiding factor to why "sell in May" works, lies in the fact that we are talking about it now and, along with lots of other people, continue to do so. That in itself makes the subject a powerful subconscious emotional tool.

It has been suggested that, generally, investors and analysts are too optimistic about the prospects for the economy and earnings outlook. They display 'optimism bias.' Another nasty old adage is 'a broker never became rich telling clients to sell stocks'; it is in most people's interest to see markets rise. As earnings are calendar events, the optimism bias also becomes beholden to the calendar. It is fairly observable that first quarter earnings are a 'wake up 'call to any over-bullish expectations. Towards the end of the year, a degree of realism will become more evident. However, there are some obvious historical and modern seasonal repetitive episodes that are relevant as well.



Source : The courtesy cycle : Ronald Q. Doeswijk 2005

In the UK, May is the third busiest month for results announcements, with 52 of the FTSE 350 reporting and it is interesting to know, on that basis, that the FTSE 100 tends to underperform the S&P 500 index by 1.9 % in May. This draws us comfortably in to the history of equity market seasonality !

In research using UK data stretching over 300 years, by Jacobsen and Zhang, it was discovered that the now vaunted positive January returns in the first 150 years, used to be lower, not higher, than for other months. A strong December effect dominated the market ahead of 1850, which has also disappeared as the January effect has taken hold. The explanation for this is accepted as being Christmas, which only started to be generally celebrated in the UK with a full holiday around 1835. If that is correct, we could expect another boost to the January effect from Christmas, when in the US, they started celebrating it with a legal holiday in 1870. Gratifyingly, that also appears to work. There is a reason for seasonality it appears!

A positive April effect in the UK (ahead of the sell in May effect), started to take hold in the 1940s, which interestingly was a long way ahead of the introduction of capital gains tax in 1965 - April being the tax year end. That long held explanation doesn't appear correct. The only persistent calendar event, detected throughout the 300 years of data, was a weak July and a weak October. However, using the Jacobsen and Zhang data over the full 300 years, the 'sell in May' trading strategy beat the

market more than 80% over 5 year tranches and more than 90% of 10 year periods.

It is also interesting to observe that, by structuring a long cyclical, short defensive portfolio, you would also be successful on the Halloween (sell in May) time periods. This implies that the summer lull is dominated by a de-gearing in 'beta' and an unwinding of the economic optimism bias from May onwards. In Ronald Doeswijk's fulsome research document of 2005, he took a long cyclical and short defensive positon during the winter and the opposite during the summer. From this, during the years from 1970 to 2003, he made an annualised 7% return on a money-balanced strategy.

He also investigated the returns on IPO's over the same period, on a monthly basis. This also dramatically corresponded to the market's seasonality. Unfortunately, I am not too sure which might be the horse and which might be the cart, but certainly speculative flows appear more likely to take a summer break, as much as you and me!

So, on to 2015 ……

I see no reason why this year should be any different from the historical precedents we have discussed. In fact certain risk timings are lining up ominously for equities. We have discussed above about earnings downgrades being a driver for poor summer performances; this has been prevalent in the U.S for a number of quarters and Q2 will continue to be adversely effected by dollar strength comparisons. The earnings comparisons themselves, are going to be 'testing' but the currency will make it a whole lot trickier.

The shares involved in buybacks have been under pressure since March, relative to the S&P. That is slightly perverse, as 'buy-backs' have been a major driver of US equity markets, post reporting seasons. Seasonally, as we move into the present calendar period, it has been difficult for 'buy back' shares, as companies are not allowed to buy their shares back during the 'closed' periods, in the month ahead of their results, thus taking away a major positive inflow of cash for overall markets.

Ahead of mid-summer, it also appears that the ECB will front load their QE in European bond markets. They intend to buy more in the liquid months of June and July and less in August. They say this is the reason and certainly there is little issuance to buy in the far summer months, but it is equally likely that they simply want to buy more bonds, via QE, into the recent heavy market weakness. Quiet bond markets, during the summer, with a stunted QE could actually be even more dangerous than usual.

By the time we hit the end of June, the certainty of the first Fed rate hike being in September will be more assured. In fact June is not ruled out, according to the FOMC minutes. Discussions of the detrimental implications of that will be rife.

The seasonal premise of 'sell in May and go away' appears opportune this year. Perhaps it will be more important to decide whether to re-invest one's summer proceeds in September, or to simply go to the St Leger and put one's money on the nice grey horse with the pretty eyelashes.

Option Sleuth

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Quite a month since I last put finger to keyboard. The Conservatives defied the polls: Deutsche Bank underwhelmed and the world has suffered a rout in government bond markets. The sharpness of some of the moves in the UK banks and energy companies belied the comment that an election morass was not priced in. Those were short-term knee jerk reactions but they have largely held and, encouragingly for the medium term, the latest Merrill Lynch survey (19/05/2015) highlights a comeback for the UK from being the least favoured country (with a net 50% of respondents underweight, among specialist European fund managers last month) to a positive net response this month. This change in the dynamic of positioning could have further to run.

We liked Centrica upside last month and it panned out well. Call premium is now cheapening since the election as 3 month implied skew widens again. There are still, however, a couple of major catalysts on the near-term horizon that could boost the stock. They have a Strategic Review on 30 July. GS, for one, see this as a potential positive, citing a "renewed focus on the core UK business and North American supply leading to a material earnings upside". They know the numbers but what I know is that very often strategic reviews can lead to outsize moves. The other catalyst is the release of provisional findings by the CMA (Competition and Markets Authority) into the UK energy market. When Ed Davey was the Energy Minister, he did not rule out the CMA proposing to break up the big six and banning variable tariffs…indeed in an Independent interview he described such moves as the "the best remedy". However Amber " I quite like seeing wind farms" Rudd, the new Energy Minister, will surely oversee a more benign outcome. The CMA release is a risk but a less than favourable result is probably priced in and the election has probably diluted its impact. In summary, I think that these potential positive catalysts in the near term are underpinned in Centrica's current stock price. With direct government intervention in the supply market now off the agenda, some potential suitors could soon be circling.

As mentioned, strategic reviews often lead to a big move in a company's stock price. The same was true for Deutsche Bank bosses on 27 April but it didn't really pan out in the way they had hoped. A little less of everything was not what investors had been looking for. Europe's very own Goldman Sachs was kiboshed, it seems, by the ECB. Too narrow a definition for the bank was too much for the ECB. There was also a lack of detail on cost cuts and concerns over the trial of Jurgen Fitschen. But there is a broader point here, the latent intervention of the ECB, as the new banking overseer, gives banks less leeway in how they restructure. It would seem that the losers from the new role the ECB has carved out are investors. Volatilty has dropped quite sharply since "Strategy 2020" was unveiled…. unfortunately it was a vision that was not appreciated by the market. DB may even still be a "volatility sell". Note this date, 9 June, the HSBC investor day.

Another catalyst. There has been a lot of conjecture recently over domicile. Some of this chatter may have been diluted by the election? Sage observers state that it would never happen. HSBC assets are materially higher than the GDP of Hong Kong and capital requirements would therefore be more onerous than they are now. They would also be under the auspices of a new regulator and may have to reapply for new licences in some 70 countries. These are surely barriers to a move. Anyhow Bernstein argue that a clean move to HK would add 40p of value of which 20-30p is already priced in…. so any pushback on the idea now could be a negative. The strategic review itself will likely see a slimming down of the bank's underperforming assets and an accelerated run off of its portfolio. Bernstein recently mentioned in a note that it sees no obvious way for management to break out of the deadlock they are in and say it will be hard for them to break 70 bps of ROTA before 2018. Any discussion of these aspects will also be closely monitored.

I think June volatility at around 20 is cheap. While we are musing about banks note another date. On 27 May Nordea Bank has a Capital Markets Day. Bigger returns are expected. JP Morgan calculates that up to 5% market cap could be returned to shareholders after taking into account new Pillar II requirements on capital.

Source: Bloomberg

Chart showing skew of JUN 15 expiry in HSBC. White line is 20 May compared to the beginning of the month. Admittedly we have had earnings but the bank is either on the cusp of a secular, maybe even historic, restructuring….or it isn't…and that's the important point.

I'd like to move on but I can't let the bond rout go without comment. As I write, it all seems a distant memory as markets recover their poise. Dynamics that caused weak positions to cover seem to be following the correct script again. Oil has stopped going up, the US economy's Q1 now looks more weather-related than it did a week or so ago and the dollar has subsequently rallied… encouraging € carry traders back in to borrow the currency and buy European assets. Chuck in the odd dovish leak from ECB officials and markets are back on point in Europe. The Japanese bond market has had these bouts of circumspection over the past twenty years which resulted in many more single women. We may just have experienced the first "widowmaker" episode in Europe.

NORTHROP GRUMMAN.

We had the NOC US AGM today (20/05/2015). They announced a 14% dividend rise, repeated their full year forecast and tweaked a few personnel. Hardly a "catalyst" and the stock bumped up a tiny amount. Nothing to get too excited about, but then again, no mention was made of the event that will change the landscape of US defence companies for ever. I'm referring to the award of the new multi-billion bomber contract by the US Air Force, which is set to be announced within the next two months….so by the back end of August. An Economist article two weeks ago explained the situation. There are two parties vying for the contract, Boeing and Lockheed on one side and Northrop Grumman on the other. The contract could be worth $50 bln to the winners
notwithstanding millions more for work on the design, support and upgrades. Normally by now a favourite is emerging but there have been no clues as to the successful bidder.

Both have their merits. Boeing has a peerless track record in building large planes and Lockheed has an unrivalled design team in radar-beating stealth technologies. However Northrop built the B-2, the predecessor to the new plane. Only 21 were ever built, as the Cold War ended, but it was still regarded operationally as a successful project.

The winner takes all …literally. The loser could end up having to give up making combat aircraft for good. There will be no more big plane deals for another 10 years, so there are big ramifications If Northrop lose, shareholders may press for it to be broken up and if Boeing lose, it may just buy Northrop's aircraft building division just to make sure it gets the deal!

The biggest winner could be Lockheed as it could be left as the only US company able to design combat planes. It's a massive decision that could leave the US defence sector looking very different by the end of the year. Northrop should not be a sub 18

EL Nino and Indian Agri outlook

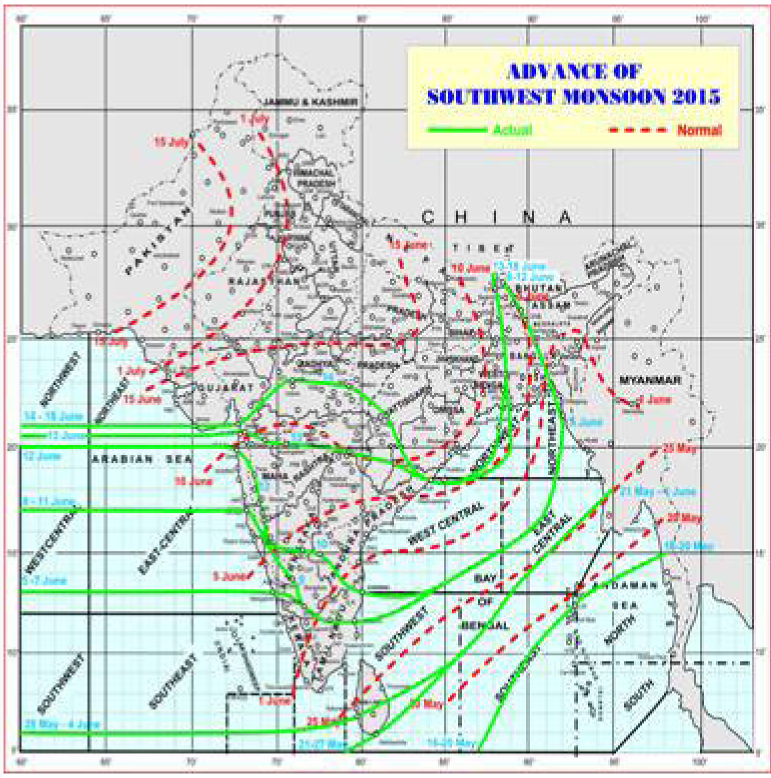
After the unseasonal rains during February and March which caused significant damage to the standing Rabi crops viz. Mustard, Wheat, Chana etc, Indian farmers and policymakers face a new weather challenge from El Nino. El Nino is a weather phenomenon caused by heating waters in eastern Pacific Ocean, which leads to changes in weather across the world. In the Indian subcontinent, El Nino leads to lower than normal monsoon rainfall.

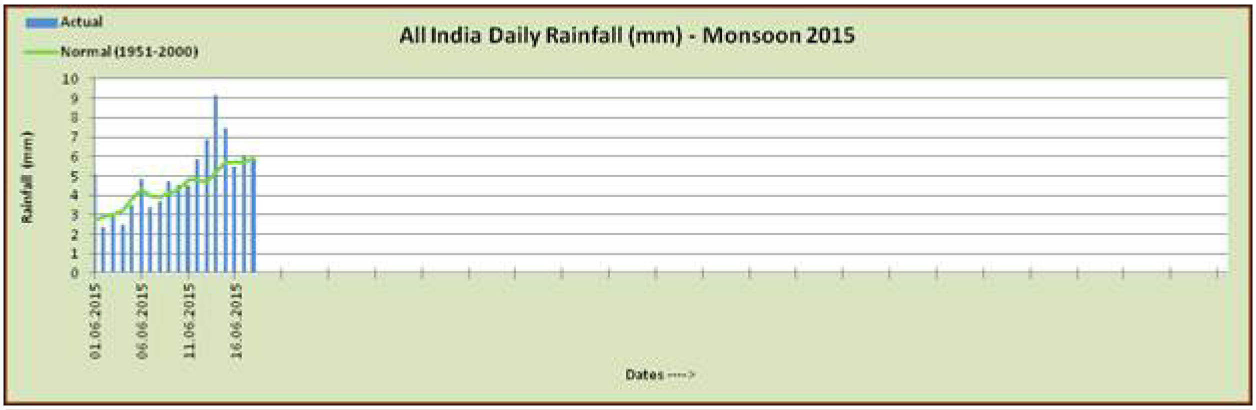
Meteorological agencies in Japan, Australia and USA have confirmed that 2015 is the year of the El Nino phenomenon. Historically, El Nino correlates well with poor monsoon rains in India. It is rare to have normal monsoon during El Nino. A below average monsoon can have significant impact on Indian agriculture output, rural income and demand, inflation and even monetary policy in India. The Indian Meteorological Department (IMD) has forecasted a deficient monsoon in 2015 at 88% of 'long period average' (LPA), lower from its initial estimate of 93%. However, private agency Skymet, forecasts a normal monsoon.

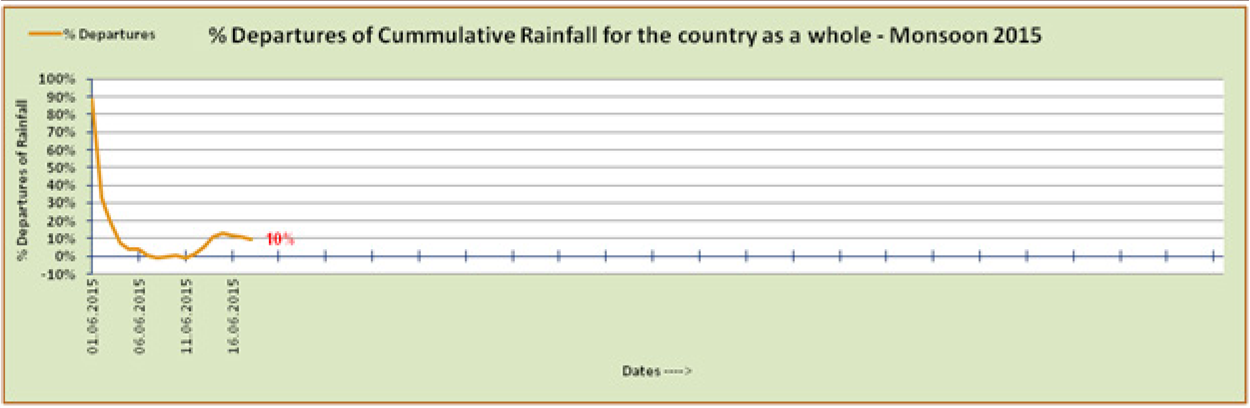
Against expectations and easing fears, the monsoon season started on a strong note in June. As of 18 June, monsoon rains in India were 10% above normal with entire peninsular India covered by monsoon but it was yet to reach north India. Crop sowing started in June amid higher reservoir levels. IMD estimated normal monsoon in June but expressed fears of deficient rains in July at 92% of LPA. Globally too, impact of El Nino so far, was muted. However, experts continue to caution that El Nino is likely to impact weather significantly in the coming weeks.

In the last 10 El Nino event monsoons, India received below average rainfall in seven monsoon seasons and normal rains in three monsoon seasons. One of the worst droughts in recent years was in the El Nino year of 2009, when, the monsoon rains were 77% of the LPA. A deficient monsoon need not translate into lower agriculture output of all crops. Different crops need different moisture to grow. It also depends on which area is most affected by deficient rains, as not all of India may receive lower rains. For eg: - the 2009 drought most affected northern and central regions of India whereas parts of south and western India received normal or even excess rainfall. IMD predicts 85% monsoon rainfall in North West India whereas above 90% rainfall is forecasted in rest of India. Non-irrigated Paddy and Sugarcane crops will be vulnerable to deficient rainfall. Crops like Cotton, Soybean and Coarse Cereals can require less but timely moisture and are therefore less vulnerable to lower rainfall. Deficient rainfall also affects Rabi crop due to lower ground water levels and partially filled reservoirs. Drinking and industrial usage limits availability of water for irrigation purposes.

Lower output in some crops does not necessarily mean higher food inflation. Other factors viz. Global food prices, currency movements etc also play an important role. CPI inflation rose sharply to near 14% during 2009. However, large domestic stocks of grains (Wheat and Rice) and Sugar should help seeing through one bad monsoon without significant import requirements. Inclement weather may severely affect short-term supply of vegetables and fruits, which may push up food inflation. A deficient monsoon may not affect food supplies significantly if managed well, but it is likely to have a significant impact in rural economic environment.


ADVANCE OF
SOUTHWEST MONSOON 2015
Actual
Normal
CHINA
PAKISTAN
MYANMAR
ARABIAN SEA
BAY OF BENGAL
ANDAMAN SEA


Actual
Normal (1951-2000)
All India Daily Rainfall (mm) - Monsoon 2015
Rainfall (mm)
Dates ---->
01.06.2015
06.06.2015
11.06.2015
16.06.2015


% Departures
% Departures of Cummulative Rainfall for the country as a whole - Monsoon 2015
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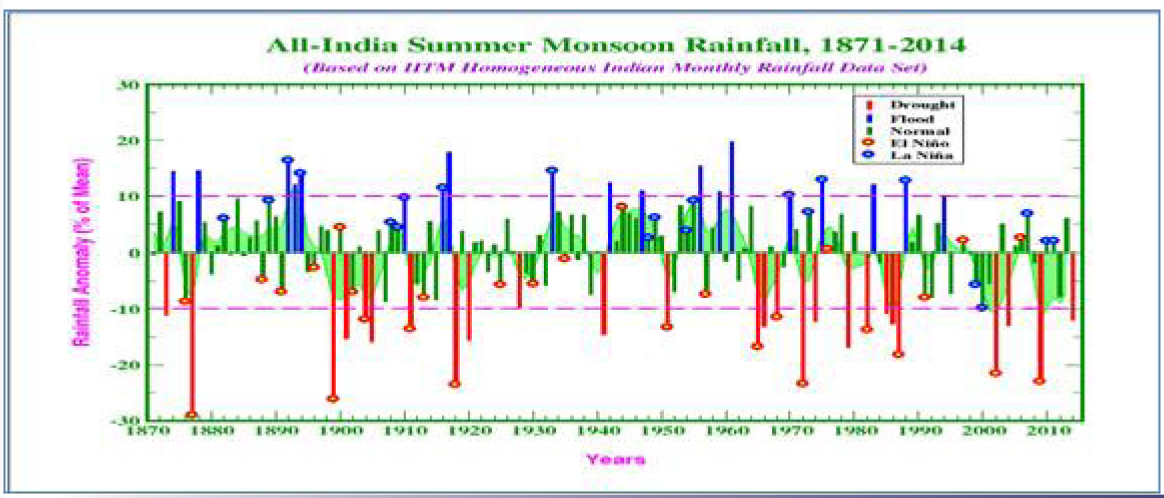
16.06.2015


All-India Summer Monsoon Rainfall, 1871-2014
(Based on IITM Homogeneous Indian Monthly Rainfall Data Set)
Drought
Flood
Normal
El Niño
La Niña
Rainfall Anomaly (% of Mean)
Years

volatility stock.

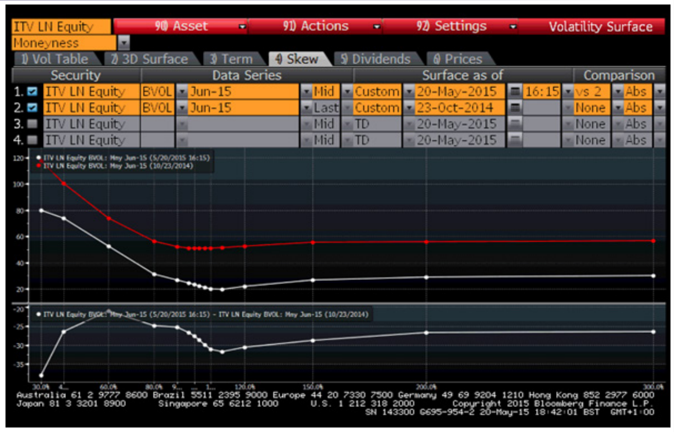
Source: Bloomberg

Chart shows AUG15 skew on NOC US. No need for comparison here. Just a low volatility stock considering the ramifications of the new bomber contract award.

ITV.

What's on the box? Well good things. ITV has turned itself round. It has ITV studios now and not only do they make great programmes, but the diversification means that ITV's income is less dependent on advertising revenues, which in any case have remained robust. Indeed, Q1 revenues were stronger across all parts of the business and with the Rugby World Cup in Q2 to look forward to, it looks set for another good year.

All this is good news and yet ITV is now the second most shorted stock among European broadcaster peers. ITV is up 105% since June 2013, so it is perhaps not unsurprising to see them shorted against a laggard – maybe TME IM (down some 25% over the same period) but ITV has been a bid rumour stock for many many months now and although the Liberty angle may have gone a little cool there are other suitors, possibly Vivendi. Whatever your thoughts or feelings, the good news is that the restrictive volatility levels we saw for an extended period from the back end of October last year no longer prevail.

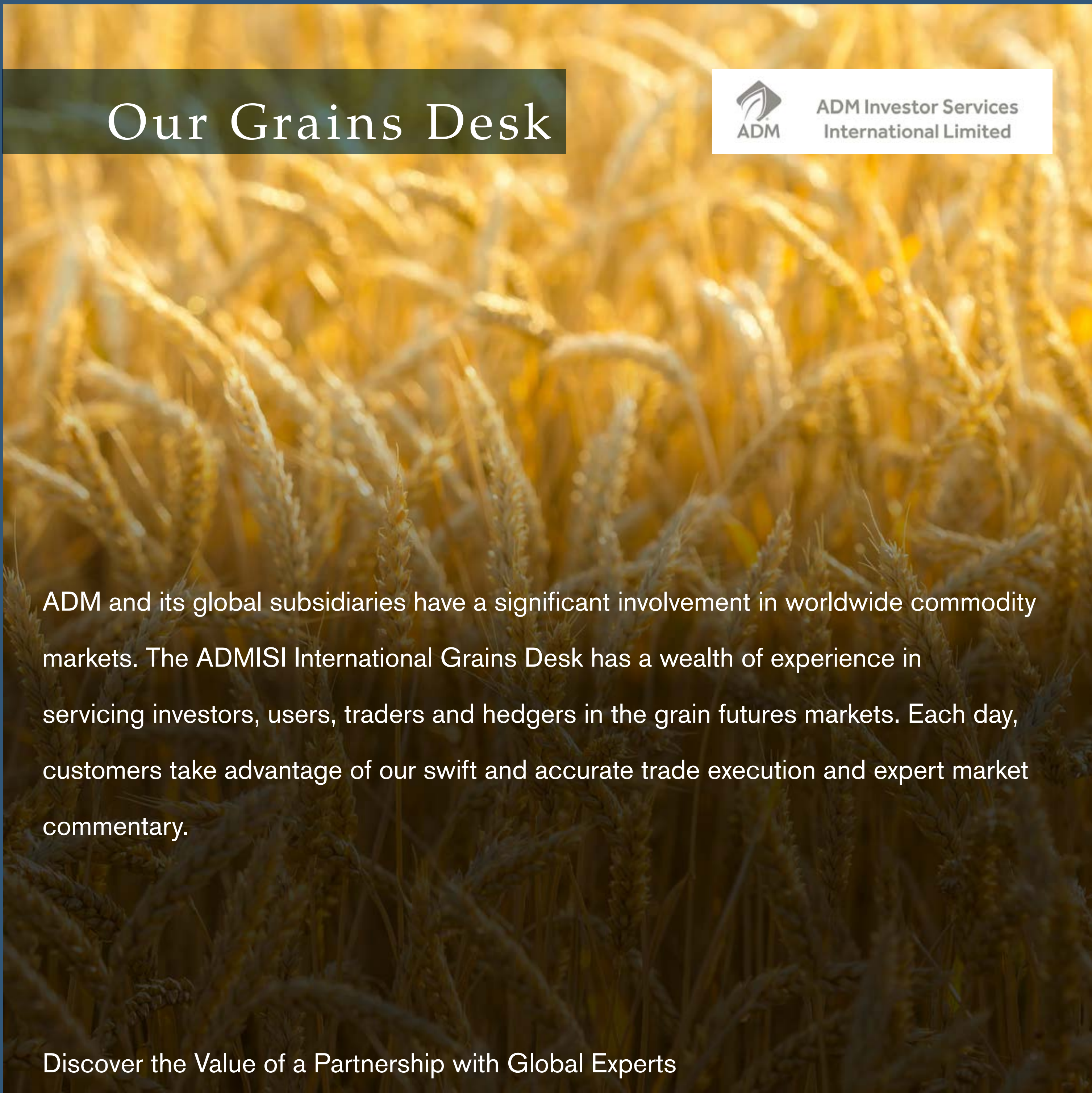


Source: Bloomberg

Chart showing JUN 15 skew in ITV. October 23 was perhaps the high point but volatility in the 30s (10% around atm strikes) were seen until March of this year. There is still some juice left in this stock.

One more thing, the OPEC meeting on 5 June is probably one of the most important of recent years. That's if you still believe that OPEC retains its status as "swing producer". But OPEC has had limited success in achieving its aims. I believe the title now belongs to the US shale industry. Markets will devote a lot of attention to this meeting but the members of OPEC appear to be pushing on a piece of string.

Until next time.



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NO Last Look?

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WHAT IS 'LAST LOOK' AND WHY WOULD IT HAVE ONCE PROVOKED VIOLENCE?

Last month I wrote an article detailing my thoughts on the SNBomb of 15 January 2015. With this still in my mind I had the opportunity this month to attend the Profit & Loss magazine Forex Network London Conference where the excellent Editor, Colin Lambert, presented.
He suggested that when he had been trading in the 1980's, if such repricing, cancellation or to use the current neutral and somewhat friendly term 'Last Look' had happened, he could expect two irate traders '...ex-members of the ICF (notorious football hooligan gang) come around my house the next morning with hammers!'. So what is Last Look and why does something that once could provoke such supposed violence be acceptable today?

Chris Concannon, CEO of BATS Global Markets, has in my opinion the clearest definition – non-firm liquidity! Pricing that is tradeable but once traded can be adjusted or even cancelled.

How has such a thing happened? It is generational, a product of the 21st Century and especially prevalent, possibly even starting, in the U.S. It was initially designed for two main reasons. In the early days of electronic FX markets it was used as 1) a latency aberration repair tool and 2) as a credit tool for counterparties.

Back in the days when we all traded in black and white, it took time for automated credit checks to happen and without the then expenditure on fast fibre optic and later microwave links (and most recently on visible/invisible light links), price latency became an issue. Last Look was instituted to allow these operations to occur. To be fair, it was a reasonable solution to such issues. However, in recent years and most especially after 15 January, it has been used by banks and more recently by non-bank market makers on any trade. Benjamin Lawsky, the New York State Superintendent of Financial Services, questioned this, 'Is this 'Flash Boys' for Forex, or is it something more innocuous?'

If it is abuse, why do custodians put up with it... apart from the generational thing? In a phrase – tighter spreads...most of the time...and this is with rejection rates of greater than 50% in some cases. This has, on the surface at least, cut the cost of trading. However, in the same Profit & Loss conference I heard a market making firm publicly saying that if Last Look was outlawed then their business model would not work. Such a comment gives the impression, if not more, of disadvantaging the customer. Additionally, not all custodians are 'equal'. With Last Look, international FX customers outside the fortresses of the US and the EU are at a latency disadvantage in our world today. Is this fair?

So – what would happen if we got rid of Last Look? Simple, prices would widen and not by a little, we could easily, initially, see spreads in say EURUSD of 0.0001 to 0.00015 or even wider from current levels. Regulation has pushed risk taking so far away from banks and further down the chain that the cost of taking such risk has risen substantially.

Additionally, forex banks which had traditionally been obliged by relevant local Central Banks to supply liquidity at all times in the most volatile of markets (though they were allowed to widen pricing), have not had such obligations imposed as the nature of traditional market making has moved away from them to the non-bank market makers. These in turn have never had such obligations – you may well ask where is the voice of the Central Banks in all this – quiet, very quiet. Such actions have in my mind lead to the events in the FX market post SNBomb on 15 January.

What can we do to amend rather than repeal Last Look? Opinion seems to fall into three areas.

- Indicative pricing – but I hear you say, we already have that from Bloomberg, Thomson Reuters, et al...
- Monitoring reject rates – but no-one making markets wants any third party to know, let alone publish, how rubbish or good is their pricing stream.
- Codes of conduct – good luck with that! At the best it will be like struggling to hold a bag of cats and at worst (more likely straight away) as soon as they are published or amended then someone will immediately try to work or write-work around...legally.

Last Look was a solution to a number of problems that happened as the market evolved with technology into the 21st Century. However, this has been adapted, in my humble opinion, to change market behaviour – no more ex-ICF with hammers – against many custodians. There is an apparent inertia to change in the market, partially because the fixing scandals have taken precedence. Even the events of 15 January have really, to my mind, failed to ignite.

With increased regulatory loads and an apparent move towards FX clearing, more questions start raising themselves. How does this environment sit with changing or cancelling deals? When is a trade finally firm? How do you bust a trade once it has gone through to clearing? Should you be able to bust such a trade? Finally, why is it that only one party in the transaction can alter or cancel the trade unilaterally?

> 'is this 'Flash Boys' for Forex or something more innocuous?'

I don't offer a solution to Last Look, I don't have one ...or at least perhaps not a currently acceptable one. Maybe it will be organic and present itself much as the way it has grown, maybe it will disappear...but for the moment it has not and also for the moment perhaps the real cost of trading is still hidden and perhaps more expensive than participants imagine.

EVENTS CALENDAR 2015

OUTLOOK

Events Worth Noting

ADMISI attend and participate in selected global events across commodities and macro economics. Should you require more information regarding these events please do not hesitate to contact your Account Executive.

Event:	Location:	Date / Month:
GAFTA	London	9 June 2015
FARO	Milan	2 July 2015
Brazil Sugar Dinner	Sao Paulo	15-17 September
LME Week	London	12-16 October
ICA International Cotton Industry	San Francisco ICA	October 2015
Sugar Dinner	India	October 2015
Coffee Dinner	Basel	October 2015
Coffee Dinner	London	November 2015

Information from External Sources

A special thanks to the following non ADMISI contributors in the subsequent pages for their thoughts and analysis. We are truly grateful for their efforts. ADMISI would like to extend the opportunity to receive additional external contributors' analysis for inclusiion in subsequent editions of 'The Ghost in the Machine.' Please contact Andy Ash for further information. Tel: +44 (0) 20 7716 8520 or Email: andy.ash@admisi.com

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Our Commodity Fund Specialist

Maleeha Bengali

"Commodities: Time to Re-engage on the Short Side!"

What to do now?

1. **Time to be short Iron ore and Copper post ~ recent 20% rally. Start shorting BHP Billiton (BLT LN Equity) and Antofagasta (ANTO LN Equity) as proxies.**
2. **Short Statoil (STO Equity) as a proxy for Brent Oil. Physical markets show slack and prices will encourage shale producers to bring back production.**

Why have Commodities rallied? The truth please...

As the esteemed Sherlock Holmes would say, "Elementary dear Watson." Coming into 2015, the positioning in investors' portfolios was so asymmetric, that even a slight change in seasonality or tone amongst central banks could rock the boat. Being long dollar has been the mantra amongst portfolio managers and sell side all through last year, and rightly so. One could be right over a year, but could be terribly wrong over a few months. That is what "unwind" means, and what we have witnessed over the past two months as seen in the latest USD CFTC positioning data as well.

Commodities are inversely correlated to the dollar. As bonds fell across developed markets, especially in Europe, the "reflation" trade has resurfaced helping the Euro to rally. Softer US data exacerbated this trend, forcing investors to take their leg off the long USD gas pedal.

As human nature dictates, a story needs to (or rather must) be assigned to any move to appease to our intellectual sides. Stories range from China recovering in light of greater stimulus efforts to softer US economic data allowing the Fed some breathing room to raise rates later than September. There is no evidence of the former, as economic data remains weak. What concerns me with regards to the latter theory is the nature of its twisted logic. If US economic data is softer, threatening global economic growth, then surely Commodities ("growth sensitive" proxies) should sell off as demand falls?

C'mon reflationists....you can't have it both ways!

Commodities are always pushed and pulled from all asset classes trying desperately hard to stand out, like the youngest child in a family of ten, but at the end of the day, fundamentals prevail and the state of physical markets dictate real price action.

So why is the Oil price up and where does it go from here?

Now that we have discussed macro tailwinds that have helped Commodities recently, let's discuss actual demand and supply in the Oil markets. There is no doubt Oil demand in developed markets ("DM") is improving vs. Emerging Markets ("EM"). Q1'15 saw US product demand up 0.9% y-o-y while OECD Europe is up 2.6%. Transportation fuels are leading the recovery and lower prices have a direct impact on consumer disposable incomes. In US, Q1'15 gasoline demand has picked up 4% y-o-y and European diesel demand by 6%. (Europe and India are more diesel-based and US more gasoline-based from a consumption point of view).

Non-OECD oil demand is sluggish. In Q1'15, it came in at best 2% y-o-y vs. ~ 4% achieved in the last few years. China oil growth was flat in Q1'15. Brazil oil demand is sagging while Russia is virtually flat in Q1'15. Even though Saudi Arabia oil demand has been holding up, some cracks are starting to appear in other OPEC countries.

The jury on a US economic recovery is out for now. US economic growth in Q1'15 was below trend due to weather-related events. Negative surprises came from manufacturing (USD effect) and consumer spending (hoarding of cash). Consumer spending still has to show signs up of a pick-up. They have been saving the majority of the "tax cut" from lower oil prices. The consensus is hopeful for a Q2 rebound (3.5% according to GS), just as in 2014, but we have yet to see evidence of Q1 just being a weather-related phenomenon. Global indicators are also showing sluggish trends. Even freight container traffic in Hong Kong, Japan, Korea, and China are falling, together with container loadings.

What does $60 WTI oil price mean for the US rig count and shale production?

The US rig count continues to decline. However the data is showing potential signs of high grading with rig increases in some of the more productive second tier counties. Among the Big 3 plays, we have seen rig counts increase in the Eagle Ford, Midland and Delaware.

US shale producers are the new "swing producers." They were quick to pull production back when WTI prices fell to $45/bbl. last year. Well production was put on hold, not cut off immediately, as producers anticipated a rally in 2H'15. With Dec'16 near $65/bbl. and Dec'17 at $66/bbl., a number of producers are "in-the-money," manifesting in increased producer hedging and a flatter WTI curve. We see signs of rigs coming back in some of the underlying data, which is consistent with some recent producer comments as well.

What is more worrying is that the speculative positioning in Oil has increased tremendously as prices have rallied. Total oil net speculative length is now just below 2014 highs. Speculative short covering has been large, but speculative longs have also moved to record highs, especially in Brent. For a sustainable oil price rally, prices need to be lower for longer, such that actual production is shut down not just put on hold.

What's the deal in Iron Ore - is there something happening in China?

The average investor looks at Iron ore and immediately thinks China. Rightfully, as most seaborne demand is generated from there. Therefore, any supportive headlines that emanate from that region are pounced upon. The state of the physical market and its shenanigans are rarely ever analysed. Physical markets can vary month on month as settlement in any given month is all about the physical balance at that time.

The strength of the recent rally originated from the 25% rally in May Dalian Iron ore futures. This outpaced both the active September futures and the USD spot Iron ore price even. As prices started to rally, several dominant short position holders found themselves unable to make physical delivery in May against their shorts.

This rally in May futures led to a vicious cycle, with May rallying leading to September rallying, leading to port price offers being lifted, leading to May rallying further, etc. There does not seem to be any shortage of physical material, it was just a matter of availability over a short window of time.

When BHP Billiton announced it would delay its Inner Harbour debottlenecking project, traders got excited a trough was reached if the Big 3 had decided to cut back. But BHP still expects to expand capacity to 270 million tonnes without additional fixed investment, and actually raised its FY2015 production guidance to 250 mt from 245 mt. Rio Tinto maintained its production targets, suggesting a large step up in quarterly shipments of 20 mt going forward. According to BHP, the market could have 100-110 mt of additional supply in 2015, while demand growth is expected to be 30-40 mt. More high-cost supply needs to be displaced.

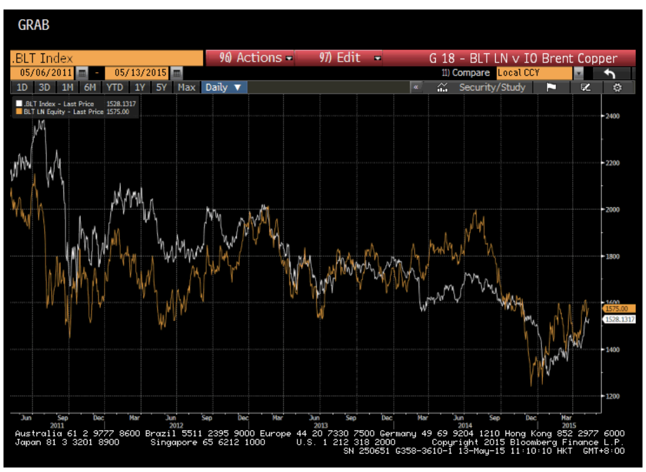
What to do now?

1) Start shorting BHP Billiton (BLT LN Equity) and Antofagasta (ANTO LN Equity) as mining sector proxies to play the short Iron ore and Copper trade:

BHP Billiton is a large cap conglomerate exposed to all the Commodities that face poor demand supply dynamics, namely Iron-ore, Copper, and Oil. The demerger of South32 was approved by shareholders and has gone ex-dividend. It currently trades on a FCF yield of 3% in 2016E, but with its top line exposed to the above mentioned Commodities, neither its yield level nor its earnings are sustainable unless one believes these prices are here to stay.

Chart 1 opposite tracks a proprietary model of BHP Billiton (orange line) vs. its benchmark of Commodities (white line). The stock tracks this basket very closely and if any of the three Commodities were to fall, so the stock.

Chart 1: BHP Billiton vs. Basket of Iron ore, Copper, and Oil



Source: Bloomberg

Antofagasta (ANTO LN Equity) is a pure play Copper mining company with limited growth so earnings correlate well with the Copper price. It has a set payout ratio based on excess net income so there is no risk of special dividends as such. The Copper scrap market is the cause of the recent copper price squeeze to $6400/t. Approximately 1-2% of Copper supply from old scrap has been cut since the Copper price fall. This has tightened the market in Q1'15. As scrap flows start to normalize now, the temporary strength in the scrap market should start to end.

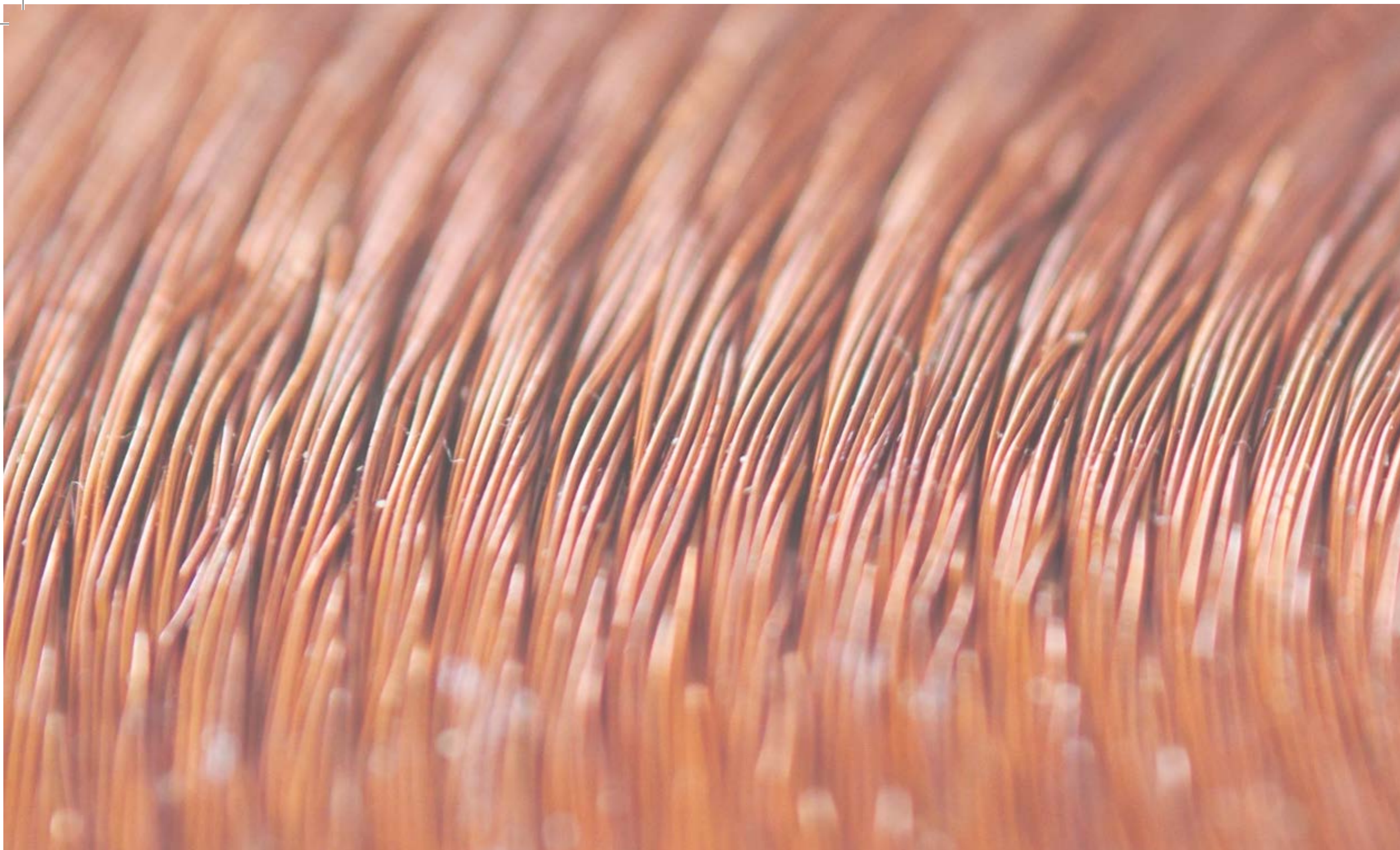
A better trade would be to short the more levered names like Cliffs Natural Resources, Fortescue Metals Group or First Quantum Minerals, but I prefer to play this trend via the large caps to avoid any potential M&A or deleveraging risk that could hit the tape given how distressed these prices are for some.

2) Short Statoil (STO Equity) as a large cap proxy for Brent Oil:

Statoil is a large cap Brent Oil proxy. There are no organic catalysts that will enable it to break away from this trend for now. It reported Q1'15 earnings and the question on investors' minds is, "Now what?" Chart 2 on next page tracks a proprietary model of Statoil (orange line) vs. Brent Oil (white line). It shows how the stock has recently outperformed its own benchmark during this recent oil price rally. Underweight positions tend to do that. As discussed on the previous page regarding Oil, it seems an opportune time to short the stock taking advantage of not only the premium it is trading on but also to play the direction of the Oil price.

Chart 2: Statoil vs. Brent Oil

Source: Bloomberg



YTD PERFORMANCE:

Portfolio	% YTD
Gross Returns (Open Positions)	2.52
Gross Returns (Closed Positions)	4.54
MBCC Net Return YTD	**6.99**
SPX YTD	4.34
Eurostoxx YTD	19.82
SXPP (Basic Resources Index)	14.60
SXEP (Energy Index)	17.50
S&P GSCI Commodity TR Index	1.95

Maleeha Bengali - Founder, MB Commodity Corner

Maleeha Bengali graduated from Cornell University with a Bachelors of Science degree in Engineering in 1997. For the past 14 years, she has worked as a Portfolio Manager/Trader for various Hedge Funds and Proprietary Trading desks across both US and Europe including UBS O'Connor, Goldman Sachs J. Aron, Merrill Lynch Commodities and Noble Group, where she launched and managed their Commodities and Equities investment funds specialising in Energy and Basic Resource Equities and the respective Commodities. Over the past 8 years, her strategy has generated a compound annual growth rate (CAGR) of 12% using systematic delta neutral investment trading strategies; minimising market and directional risk while maximising returns, focusing on alpha generation.

ADMISI Gibraltar Branch

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- Full risk management and post-trade reporting transparency

Algorithm Analyst

ALGO TECHNOLOGY LIMITED

Anthony Edwards

Methodolgy:

The basis of our approach to analysing asset prices is that the price of an asset reflects the market's view of all the public information about that asset. By analysing how prices have changed over time, we can gain insight into how market participants typically react to changing information and hence determine how prices are likely to change in the future.

What are Algos?

We use algorithms, or 'algos', that we use to identify potential entry and exit points for trading assets. Algos typically look for patterns that are occuring in an asset's price now which have occurred historically. By then looking at those historical occurences, the algo can determine what typically happens to the asset price. Using this approach, we aim to bring a scientific and statistical approach to determining investment opportunities. Our Algos: The list below shows a brief description of the algos available on this site. For our bespoke services we can create customised algos, so please contact us if this service is of interest.

SIGNAL ALGO - The 'Signal Analyser' identifies technical signals that are firing on assets that have a proven track record of success. By 'signals' we mean discrete binary events such as the 2 week price performance being above 10%, or the 20 day Relative Strength Index being below 30. As you raise the performance levels, this algo will identify fewer assets albeit with higher conviction. We suggest using a sharp ratio setting of 2.0 or more to identify high conviction ideas.

HIGH VOLUME ALGO - The 'High Volume' algo identifies instances where there has been a significant price movement with significant volume. These tend to occur when news has been released that significantly affects investors' perceptions of asset prices. This algo therefore identifies assets where recent events have altered investor sentiment.

OVERBOUGHT / OVERSOLD ALGO - The 'Overbought/Oversold' algo uses a self-scaling relative strength indicator to identify assets which are in either oversold or overbought conditions and at the point when typically the price action begins to mean-revert. This enables the reversal levels to be tuned to the strength of the trend of an asset.

CORRELATION ALGO - The 'Correlation Algo' identifies which technical factors are the most highly correlated to future asset price returns. By 'factors' we mean continuously valued variables such as the 2 week price performance and the 20 day Relative Strength Index. The algo then identifies what typical future returns occur when those factors are similar to where they are today.

TREND ALGO - The 'Trend' algo identifies the direction and strength of a price trend using a proprietary methodology based on a range of moving averages and the position of the price relative to these moving averages.

Anthony Edwards gained a 1st class honours degree in Elecrical and Electronic Engineering at the University of Bath and went on to earn a PhD based on research into power system stability using artificial intelligence techniques. He started working in the City of London in 1998 for Bankers Trust and subsequently became Head of Research IT Development for Deutsche Bank in London. In 2007 Anthony joined Liberum Capital to build out their global quantitative research platform. In 2011 he left Liberum Capital to start AlgoTechnology Limited which specialises in developing bespoke quantitative and technical algorithms and also in developing portfolio strategies.

Algorithm Analyst

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+ Positive Signals

Positive Signals	Best Signal	Horizon(d)	Avg Return	Sharp	
Bellway	+10	On-Balance Volume / OBV(55d) signal	60	12.2%	2.9
Gjensidige Forsikring ASA	+8	Commodity Channel Index / CCI(144d) signal	60	23.6%	5.0
Synthomer	+8	Force Index(144d) signal	40	10.2%	4.9
Glanbia	+8	Force Index(89d) signal	60	19.5%	2.1
Betfair Group	+8	Price Volume Trend(55d) signal	60	23.4%	1.8
Synergy Health	+7	Relative Activity Index(55d) less than 30	20	8.1%	4.6
Berkeley Group Holdings	+7	Price Volume Trend(89d) signal	60	12.0%	2.9
Flughafen Zuerich AG	+7	Long Parabolic SAR (0.02,0.2) signal	60	7.0%	1.4
Greggs	+6	Force Index(233d) signal	60	36.1%	6.8
Enagas SA	+6	Commodity Channel Index / CCI(144d) signal	60	8.6%	3.5

- Negative Signals

Score	Best Signal	Horizon(d)	Avg Return	Sharp	
Anite	-3	RSI and RAI(21d) greater than 70	40	-9.0%	1.1
Afren	-3	RVI(233/10d) less than 70	60	-257.0%	1.5
esure Group	-2	RSI and RAI(21d) greater than 70	40	-4.3%	1.0
Neopost SA	-2	Simple Moving Average / SMA(89d) turning downwards	60	-5.3%	1.1
Outotec OYJ	-2	Exponential Moving Average / EMA(55d) turning downwards	60	-3.0%	1.1
Anglo American	-2	Simple Moving Average / SMA(34d) turning downwards	60	-5.0%	1.3
Evraz	-2	Relative Activity Index(55d) greater than 70	20	-6.5%	1.4
Kenmare Resources	-2	Relative Activity Index(34d) greater than 70	40	-28.0%	2.0
CGG	-1	Price crossing down through SMA(55d)	60	-6.5%	1.0
Oxford Instruments	-1	RSI(34d) greater than 70	60	-16.7%	1.1

The **AlgoAnalyst** uses a range of bespoke algorithms to identify the probable future direction of asset prices from time horizons from 1 week to 6 months. These algorithms look at a wide range of technical factors and signals and use backtesting to determine patterns and correlations in the data that have yielded consistent returns in the past. The algorithms can be individually tailored to each user's criteria such as investment horizon and risk/reward profile. The system itself covers a wide range of equities and equity indices and clients can create their own portfolios in the system to provide alerts for idea generation and risk management. In addition, the system provides the **'Portfolio Doctor'** which can be used to suggest potential replacement ideas for existing portfolio positions.

Algorithm Analyst

ALGO TECHNOLOGY LIMITED

+POSITIVE

Signal Algo - Top 10

Bellway	+10
Gjensidige Forsikring ASA	+8
Synthomer	+8
Glanbia	+8
Betfair Group	+8
Synergy Health	+7
Berkeley Group Holdings	+7
Flughafen Zuerich AG	+7
Greggs	+6
Enagas SA	+6

Correlation Algo - Top 5

Jimmy Choo	+1
Greggs	+1
Gjensidige Forsikring ASA	+1
Enagas SA	+1
Marine Harvest ASA	+1

Oversold Algo - Top 5

Synergy Health	+1
Gjensidige Forsikring ASA	+1
Elekta AB	+1
BBA Aviation	+1
De La Rue	+1

Trend Algo - Top 5

Redrow	+2
Synthomer	+2
Elisa OYJ	+2
FLSmidth & Co A/S	+2
Rightmove	+2

Overall Most Positive

Bellway	+12
Glanbia	+11
Betfair Group	+11
Synthomer	+9
Berkeley Group Holdings	+9
Hermes International	+9
Greggs	+8
Rightmove	+8
Flughafen Zuerich AG	+8
Gjensidige Forsikring ASA	+7
UCB SA	+6
Synergy Health	+5
Elisa OYJ	+5
Enagas SA	+5
Celesio AG	+5
Redrow	+4
BBA Aviation	+4

High Volume Algo - Top 5

Elisa OYJ	+1
Hermes International	+1
Celesio AG	+1
Vesuvius	+1
UCB SA	+1

Algorithm Analyst

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—NEGATIVE

Trend Algo - Top 5

Air France-KLM	-2
Allianz SE	-2
Ansaldo STS SpA	-2
Arkema SA	-2
Autogrill S.p.A.	-2

Signal Algo - Bottom 10

Anite	-3
Afren	-3
esure Group	-2
Neopost SA	-2
Outotec OYJ	-2
Anglo American	-2
Evraz	-2
Kenmare Resources	-2
CGG	-1
Oxford Instruments	-1

Overall Most Negative

Afren	-5
Outotec OYJ	-4
Anglo American	-4
Evraz	-4
Arkema SA	-3
Neopost SA	-3
AP Moeller - Maersk A/S	-2
Air France-KLM	-2
Allianz SE	-2
Ansaldo STS SpA	-2
Autogrill S.p.A.	-2
esure Group	-2
CGG	-2
Anite	-2
Aalberts Industries NV	-1
Akzo Nobel NV	-1
Alstom SA	-1

Correlation Algo - Bottom 5

ASM International NV	-1
Accor SA	-1
Akzo Nobel NV	-1
Alent	-1
Alstom SA	-1

Overbought Algo - Bottom 5

Ultra Electronics Holdings	-1
Valiant Holding	-1
esure Group	-1
Oxford Instruments	-1
Anite	-1

High Volume Algo - Top 5

3i Group	-1
AP Moeller - Maersk A/S	-1
ASM International NV	-1
AXA SA	-1
Aalberts Industries NV	-1


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