Macro Outlook

January 2015

This is an overview of the four market sectors we trade based on a consideration of macro- economic and price indicators with a view towards identifying trend potential.

Foreign Exchange - Structurally USD positive. Near term USD positive.

The US Dollar (USD), as measured by the USD Index, strengthened by13% in the second half of 2014 and has recently reached its strongest level since 2005. We believe this recovery marks the end of a 30 year USD bear market and that a secular bull market is underway.

Chart 1: USD Index since 1984 - Early days in a new bull market

Source: Bloomberg

The impetus for the move in recent months was provided largely by policy outside of the United States - namely explicit and concerted efforts on the part of the European Central Bank (ECB) and the Bank of Japan (BOJ) to weaken their respective currencies. On September 4th last the ECB indicated an intention to radically increase the size of its balance sheet, employing the 'portfolio rebalancing and signalling channels', with a view toward encouraging market participants to drive the Euro lower. In this respect the ECB is attempting to replicate BOJ policy of the past two years and combat falling inflation through a substantial weakening of the currency. On January 22nd the ECB followed through, launching a programme of quantitative easing involving the purchase of over €1 trillion of assets.

On October 31st last the BOJ expanded its Quantitative and Qualitative Easing program as the sales tax increase and the falling price of energy threatened to undermine their efforts to stimulate the economy. The BOJ outlined a plan to purchase

Japanese Government Bonds at an annual pace of 80 trillion yen. This amount corresponds to 16% of Japan's GDP, 7% of its outstanding gross government debt and twice its estimated 2014 budget deficit. At this rate we calculate that the Bank of Japan will hold close to 25% of gross government debt by December 2015.

In relation to the commodity currencies the prevailing dynamic between 2002 and 2011 was of a commodity bull market and a weak USD leading to commodity currency strength. This dynamic is now in reverse. A shift away from an over reliance on resource intensive growth in China combined with ample supply in many commodity markets has been driving commodity prices down. The Australian, New Zealand and Canadian dollars are reflecting this changed landscape and their respective central banks are actively encouraging the moves.

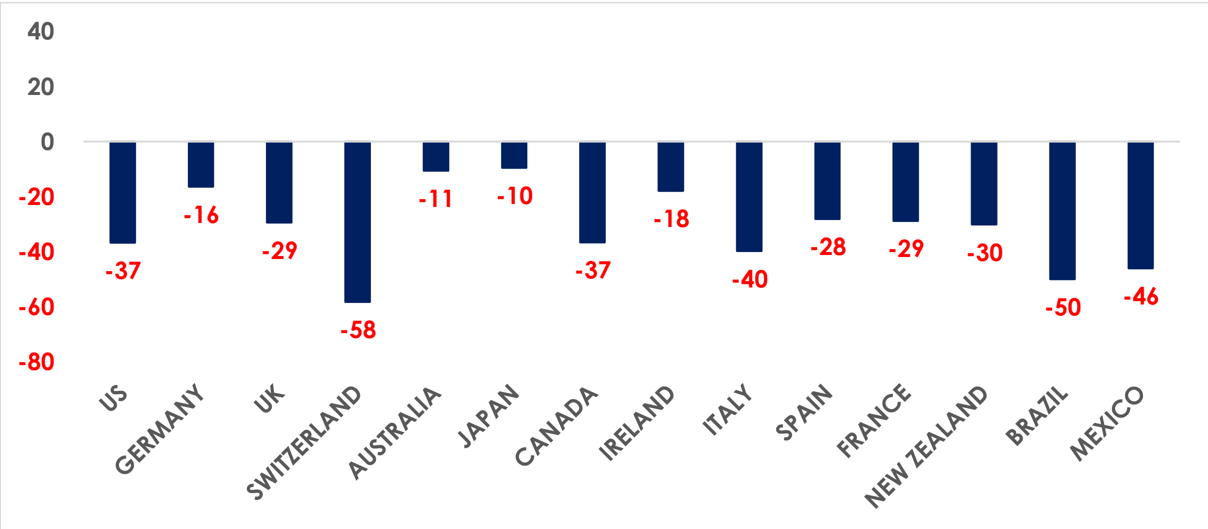
While we anticipate that the Federal Reserve will normalise monetary policy gradually, policy direction stands in contrast to that of other major central banks. US policymakers recognise a weak international environment, particularly in Europe and Japan, as a threat to their own interests and on that basis have been prepared to acquiesce in the currency devaluations currently underway. More broadly, the United States looks something of an oasis in an uncertain global economic environment with clear strategic advantages in technology, energy, demographics and economic flexibility over its competitors.

The environment in foreign exchange markets has changed since the first half of 2014 when volatility in the sector fell to historic lows. Trends are now in place and in our view they should be respected. Our favourite FX trades right now are Short EUR/USD and Long USD/CAD. We believe 1.0000 and 1.3000 respectively are realistic objectives in 2015.

Interest Rates - Structurally Neutral. Near term Neutral.

The year has begun with an acceleration of the bull market and sovereign yields are already sharply lower.

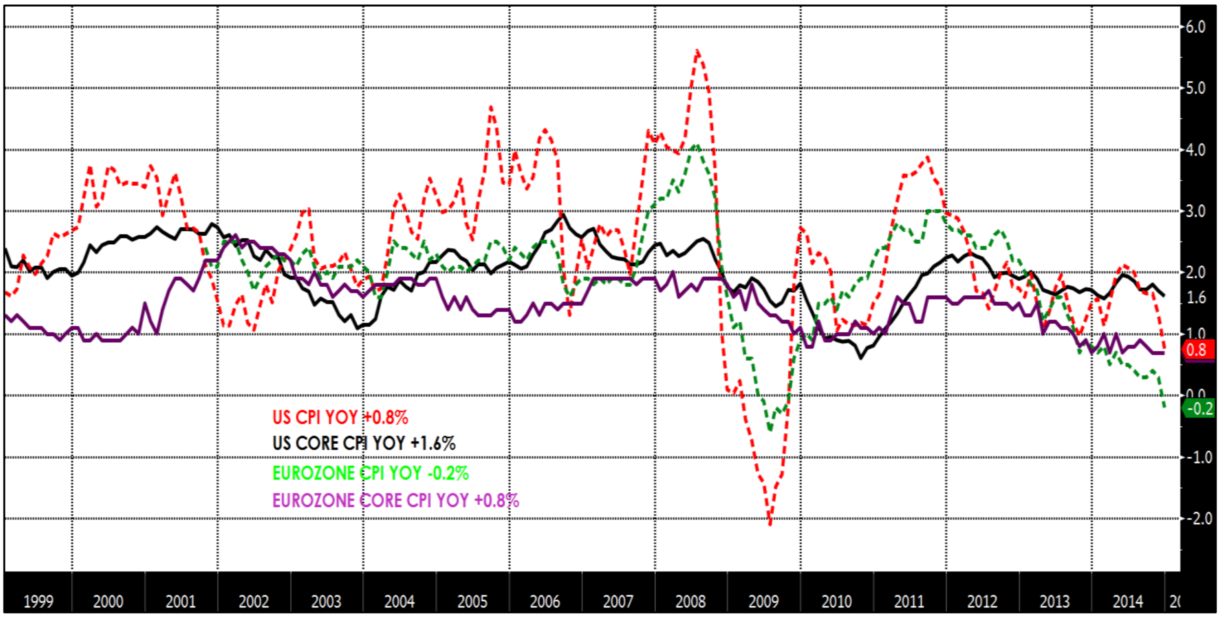
Chart 2: Changes in 10Yr Bond Yields in 2015 (Basis Points) - Jan 23rd



Source: Bloomberg, Three Rock Capital

Headline inflation has begun to fall sharply as a result of the collapse in energy prices. In the Eurozone it turned negative in December and indices in the United States and Japan will almost certainly do likewise by the summer.

Chart 3: CPI in US and EUROZONE 1999 - 2015



Source: Bloomberg

We have felt for some time that central banks in developed economies are obliged to maintain very accommodative monetary policies until government debt to GDP ratios are trending downward and / or inflation is on an upward trajectory. The collapse in energy prices will serve in the short term to reinforce unconventional monetary easing in the Eurozone and Japan and to delay a planned gentle exit from such policies in the UK and to a lesser extent in the US. Elsewhere, Canada, Switzerland and Denmark have lowered policy rates since mid -January.

The decline in headline inflation is expected to be transitory while the net effect on employment, consumption, and growth should be firmly positive for developed economies. So while the collapse in energy prices acts as a support for interest rate markets in the short term, we expect this support to fade as substantial positive growth effects are felt.

The extent to which 'medium term inflation expectations' are impacted by the collapse of energy prices will be central to monetary policy developments in the coming months. At this point the Federal Reserve and Bank of Japan expect inflation expectations to remain well anchored, the European Central Bank is acting to counter declining medium term inflation expectations while the Bank of England sees mixed signals:

> ***CHAIR YELLEN.*** *Well I—I'd say, you know, that I think what we have seen since the mid-'80s is that,* ***in an environment where inflation expectations are well anchored, that movements in oil and commodity prices and import prices tend to have transitory effects on the inflation outlook…….. And I think that's the Committee's expectation here.*** *Inflation, even core inflation, has been running below our inflation objective. Movements in oil, you know, now down and perhaps later up, will move inflation*

around, certainly headline inflation. But the Committee, at this point, anticipates those impacts to be transitory. So as long as participants feel reasonably confident that the inflation projection is one where we expect to meet our 2 percent objective over time, that's what I think how they'll be looking at things as we decide on the path for the funds rate.

FOMC Press Conference December 17th, 2014.

Bank of Japan: *Inflation expectations appear to be rising on the whole from a longer term perspective.*

Bank of Japan - Statement on Monetary Policy January 21, 2015

***Mario Draghi**: We have had low headline inflation in the past driven by energy prices – it was even negative in 2009. But at that time, core inflation was already moving upwards as the economy was rebounding, which provided us with comfort that inflation would pick up over the medium-term. This time around, the overall picture is different…………….... if inflation expectations fall, the* real *interest rate rises, which is the interest rate that matters most for investment decisions. And because nominal short-term rates in the euro area have already reached the effective lower bound, they cannot be adjusted downwards further to compensate for this. In other words, any de-anchoring of expectations would cause an effective monetary tightening – the exact opposite of what we want to see*

ECB: Monetary Policy in the Euro Area - Mario Draghi - November 21, 2014.

***Bank of England:** It was not clear whether medium - term inflation expectations had genuinely held up (in the UK) more than elsewhere or whether there were market factors that had distorted the signal about inflation expectations that could be extracted from inflation swap rates…Members put different weights on the contrasting signals from household and market implied measures of medium term inflation expectations. The balance of evidence pointed to inflation expectations remaining well anchored to the 2% inflation target over the medium term. There was some concern about the pace of decline in all measures of inflation expectations, in the United Kingdom and internationally, especially as there could be more downside news on inflation to be digested. All members agreed that different measures of inflation expectations across major countries needed to be monitored closely in the months ahead.*

BOE - Minutes of the Monetary Policy Committee Meeting January 7 and 8, 2015.

In summary, from a trading point of view we are neutral on the sector currently. Historically low and in some cases negative yields discourage us from being structurally bullish of interest rate markets while as the year goes on we expect dis-inflationary pressures to fade and growth to strengthen. Against that, we respect the strong price trends in place and struggle to envisage inflation on a strong upward trajectory anytime soon.

Equity Indices - Structurally Positive. Near term Positive.

We produced a short piece in June 2014, 'Six Reasons to be Structurally Bullish of Equity Indices', outlining what we believe are structural forces which will continue to support the capacity of multinational firms to generate strong earnings in the years ahead. Our thinking on this still holds. We are constructive on equities in 2015 particularly in Europe. In the first three weeks of 2015 the Euro has depreciated over 20% against the Swiss franc, almost 10% against the Japanese Yen and 8% against the USD. This powerful tailwind combines with the ECB's quantitative easing program to push investors toward European equities. In addition we see the prospect of a positive growth surprise in Europe this year driven by cheaper energy.

Chart 4: Euro versus other major currencies in 2015

Source: Bloomberg

On January 16th the Dax broke out of a year-long trading range between 9000 and 10000. The fundamental backdrop outlined above supports this move. We think the Dax could rally 20-30% in 2015.

Chart 5: Dax Breakout - Jan 16th, 2015

Source: Bloomberg

In the US, the strong USD is a headwind for earnings though the recent decline in bond yields an important positive. We note expectations for S&P earnings growth in 2015 have been revised from +10% a month ago to +4% now. We believe US equities will post modest gains in 2015 but that the prospects for the best returns are in Europe. As a consequence we are focused on the Dax.

Precious Metals - Structurally Neutral. Near term Neutral.

Price action recently in precious metals has been interesting. We had been structurally bearish in Q3 and Q4 of 2014 against the backdrop of a USD bull market and commodity bear market. We had a short position in Silver which we covered in October and have not been active in the sector since. Yet despite a rampant USD and weak commodity prices precious metals are rallying. The disinflationary backdrop may have changed the landscape. It seems to have focused attention on the difficulty central banks are experiencing in managing policy to their targets. The Swiss National Bank abandoning the peg to the Euro appears to have reinforced this thinking. The logical conclusion of this line of thinking is yet more easing. As mentioned earlier we suspect disinflationary pressures may ease as the year gresses. This is holding us back on a bullish stance on precious metals for now but we are more inclined towards a bullish perspective than for some time.

Chart 6: Is Gold turning up?

Source: Bloomberg

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