COMMENTARY

April 17, 2014

Dear clients and colleagues,

You may recall our comments on November 8th and October 11th 2013, about risk and momentum being the trades working and the question asked was are we in another stock bubble? Or just a tech bubble? Since the beginning of March, stocks with low valuations started to outperform the market. The worst factors since then are 12M price performance and High Forward P/E. What caused this reversal and what is ahead?

If history is any guide, we believe this shift to quality and more reasonable valuations is a healthy development for markets and should last a few years.

Since the crash of 2008, US and many global stock markets have been in a bull market and are up over 175% from their lows, over 200% for the Nasdaq and small cap stocks. This has brought out many comments about stocks being expensive and the upcoming correction.

However, in the last few years, many stocks that are bell weather for the global economy have not participated in this rally. What we have observed YTD is those companies are outperforming. For example, since the beginning of March, Microsoft is up 3.6% whereas Facebook is down 13%.

What has caused the momentum breakdown?

Source: J.P. Morgan Derivatives Strategy, Bloomberg.

The graph on the righ shows YTD performance of the S&P500 Industry group (vertical) against performance in 2013 (horizontal). How long will the shift out of momentum continue? It is hard to say, but with markets having ignored risks (economy, geopolitical, valuation) in the last two years, we believe that valuations will once again matter.

On another note, we have seen the resurgence of M&A activity in Q1 of this year to a total of US $600B, with domestic M&A up 16% to US $344B and cross-border up 67% to US $255B. In the US, the value was up 56% to US $277B, in Europe it was up 19% to US $160B and in Asia (ex-Japan) it was up 36% to US $102B.

This is a very positive development particularly for small cap because it represents over 90% of the transactions. The average deal size in Q1 2014 was US$ 374M. TMT had the highest share of M&A at 29% and the highest Q1 since 2006. Technology M&A had its highest Q1 ever. Pharma and medical were over four times Q1 2013. Finally, private equity exits reached the highest Q1 since 2001.

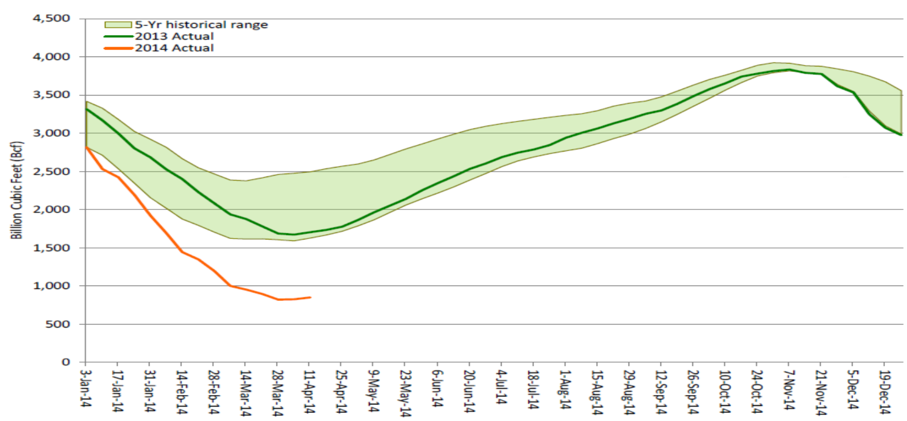
On a last note, after a very harsh winter, US natural gas prices are now firmly above $4. The injection season is upon us and bringing out a lot of bears who were forecasting long term prices below $3. We believe that natural gas prices will stay above $3.50 and will most likely move towards an equilibrium price of $5.50 -$6.00 by mid-2015.

The reasons for our optimism are:

- Below $5.50, it is still non economical to drill for dry gas.
- The high decline rates combined with low drilling has reduced production.
- Demand is strong with energy and industrial demand at record high.
- The first LNG export project will come on-stream in late 2015.

Below is a chart of the inventories at the moment.

Total DOE Natural Gas Inventory



Source: Bloomberg, Department of Energy and Enercom Consulting.

Have a good Easter.

The Global Alpha Team