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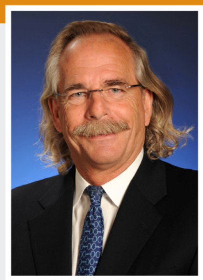

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The Euro Seems Poised for a Fall

November 5, 2013

After rallying 14.4% against the US dollar since June of 2012, the euro seems poised to fall. A recent very weak CPI (Consumer Price Index) reading of 0.70% may act as a signal for the ECB (European Central Bank) to ease at this Thursday's ECB meeting. Adding more fuel to the fire was this morning's announcement by the European Commission that the euro area's economy will expand by only 1.10% in 2014 vs. earlier estimates of 1.20%. In addition, the Commission expects the unemployment rate to increase from 12.10% to 12.20%. This nasty combination of weaker growth expectations and disinflation could deepen Europe's current economic woes if not addressed.

The US dollar has benefited from an unexpected increase in the ISM Manufacturing Index (Institute for Supply Management) last week which was followed by an unexpected increase in the ISM Non-Manufacturing Index this morning. This Friday, the October employment data will be released and the bar seems to be set quite low for an expected increase of 120,000 vs. the 148,000 jobs created in September. The potential for the ECB to lower rates this coming Thursday, or at least address a potential of lowering rates in December, followed by an upward surprise in the employment data, could send the euro sharply lower against the US dollar.

Investors who have anticipated a European recovery and a stronger euro may have to re-address their views. Since last Friday, US 10-year yields have risen from 2.51% to 2.65% with German yields moving from 1.75% to 1.74%. This divergence in yields has clearly favored the US dollar and has been supported by stronger US economic data.

There is a rising risk that ECB's President Mario Draghi will sound very dovish at this Thursday's press conference given the recent weak economic and inflation data, not to mention the just-announced economic downgrade by the European Commission. This is in contrast to the FOMC statement issued last week in which they removed the statement: "***the tightening of financial conditions observed in recent months, if sustained, could slow the pace of improvement in the economy and the labor market".*** In short, a more dovish ECB and a less dovish Fed should make for a weaker euro.

Should Friday's employment data in the US prove stronger than expected, US 10-year yields would likely begin an earnest move back towards the 3.00% level. Unfortunately, many investors bought into the bond market when yields started moving up from 2.50% last week. Investors may also make an even bigger mistake by purchasing short-dated notes in the 2-5 year sector once the Fed begins to taper. The expectation is that yields at the front end of the yield curve will decline once the Fed starts tapering. However, we believe that tapering will push long term yields higher and in turn will pull short term yields along with them.

For example, since May 21st when the initial talk of tapering began, the 2-year Treasury note has lost 1.30% in price, with the 10-year Treasury note losing 5.70%. The 2-year note may be safer but is clearly not protected from a rise in yields.

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