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Quarterly Investment Bulletin

April 2013

General Economic Overview – Quarter One 2013

The first quarter of 2013 saw a continuation of the stock market performance seen towards the end of 2012 with strong returns across most equity markets, although momentum started to slow towards the end of the quarter. The beginning of 2013 saw a partial resolution to the US fiscal cliff, which had been concerning investors and had led to underperformance from the US stock market in particular. This removed one of the perceived headwinds to global stock markets and followed on from the reduction of risk in Europe and the relatively smooth changes to the leadership in China.

Levels of global economic growth remain below trend and this is expected to continue for some time but there are pockets of optimism. Data from the US remains broadly positive, particularly from a consumer perspective with unemployment, housing and retails sales data continuing to improve. Changes to the country's Prime Minister and governor of the Bank of Japan together with the implications for policy change was very positive for Japan and the third quarter of 2012 is looking increasingly like the bottom of the recent economic growth downturn in China. Problems remain in Europe with low / no economic growth overall and a disconnect between the stronger 'core' European economies (it is increasingly looking like Germany is alone in this category with France and Italy weakening) and the weaker peripheral European economies (Spain, Greece, Portugal). The UK is faring little better, as growth also remains relatively weak, inflation has not been tamed and government debt levels are expected to fall much slower than originally anticipated.

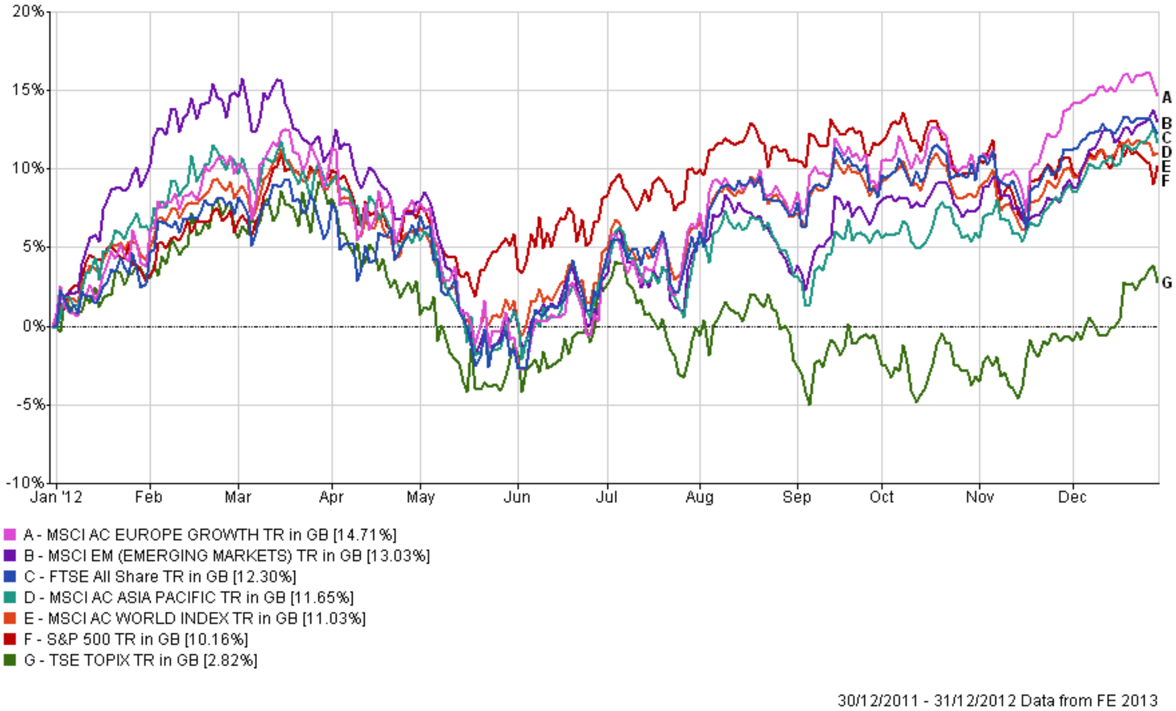
Central banks continue to be relatively active with the Bank of Japan the latest to be linked with a significant monetary stimulus programme. This follows continued efforts from the US Federal Reserve with their monthly purchase of US Treasuries and Mortgage Backed Securities, on-going, but not additional, Quantitative Easing from the Bank of England and the possibility that Mario Draghi and the European Central Bank will introduce further monetary policy as and when required. This means liquidity is likely to remain abundant.

Investing within the current economic and investment environment is difficult, particularly within equity markets, as the perceived benefits or disadvantages of particular monetary, fiscal and political policy is not easy to decipher. For example, if the US Federal Reserve were to reduce their Quantitative Easing programme, is this a positive thing due to the likelihood that economic growth is deemed to be strong enough to manage with this reduction, or is this a negative thing due to the reduction of liquidity in the system, which has helped drive equity markets? Similarly, if the ECB were to introduce more Quantitative Easing, is this a positive thing due to the added liquidity this will provide and the support for beleaguered economies this would provide or is this a negative thing, an admission that current conditions are extremely difficult and economies are struggling to survive?

As always, the valuation of a particular asset class provides a good starting point for determining the likely future longer-term returns but the current economic and political environment means that there will be shorter-term volatility and different times when 'safe-haven' and 'risk' assets outperform.

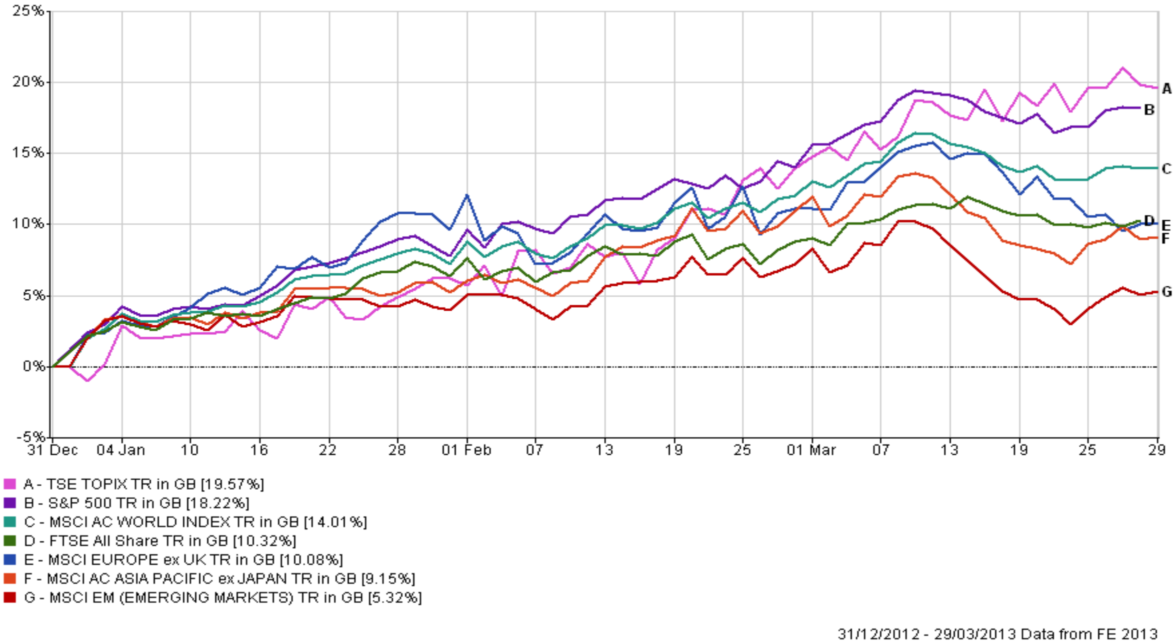
Equity Markets Overview

Chart showing 2012 returns for major market indices:



Equity markets performed better in 2012 than many investors had expected and, as can be seen from the chart above, with the exception of Japan, each of the major markets produced a return of between +10% and +15% in sterling terms.

Chart showing Quarter One returns for major market indices:



The first quarter has been quite different to 2012 with Japan leading the way, closely followed by the US – both these regions underperformed in 2012. By contrast, emerging market equities, which outperformed in 2012, were the worst performers during the first quarter. Europe had a particularly strong start to 2013 but the economic and political problems have not disappeared and this caused investors to take stock on their recent gains. The UK had a solid quarter with significant dips or gains helped by the global nature of the stock market. Relatively poor performance of some of the major Asian equity markets, Hong Kong, China, India meant that the region underperformed as a whole and this, combined with disappointing performance from the likes of Brazil and Russia, resulted in the underperformance of the emerging markets.

Markets continued to positively re-rate during the quarter but there are signs that correlation between stocks and sectors is starting to diminish and that individual company performance and earnings improvements will be a bigger driver of stock performance during 2013 than it was during 2012 when macroeconomic influence was high. Equity market valuations remain attractive over the longer-term, particularly relative to most government bond markets, and provide a good entry point to investors, with emerging markets potentially being of interest following their recent underperformance.

Sector Review

UK

The UK economy continues to struggle with GDP growth for 2012 confirmed at a very weak +0.2%, which includes -0.3% for the fourth quarter. Expectations for 2013 are not significantly better with the Chancellor of the Exchequer announcing in the March budget that the Office for Budget Responsibility (OBR) has, once again, revised down its growth expectations for 2013 with their December forecast of +1.2% now revised down to +0.6% and projections for 2014 and 2015 also revised downwards. This has meant that government borrowing levels will not come down as quickly as expected and deficit levels will remain higher for longer. This follows downward growth revisions from the OECD (mentioned last quarter), IMF (down to +1% for 2013) and a further downgrade from the NIESR (to +0.7%).

These low levels of growth are likely to mean that interest rates are on hold for even longer than currently expected and there may even be room for a further interest rate cut to 0.25%, but this is not currently expected. The introduction of more Quantitative Easing (QE) is more likely with three of the nine Bank of England members having voted for an increase in February and March. The March budget has provided the Bank more flexibility in the setting of their monetary policy, and it is anticipated that this will be used by the new Governor, Mark Carney, when he takes over in the summer. The potential sticking point to the introduction of more QE is inflation with March's figure of +2.8% the highest level since May 2012.

Despite the current economic situation and outlook, companies remain in a relatively healthy financial position with dividends to investors remaining strong due to good cash generation. This has been helped by the fact that approximately 80% of the revenues generated by companies in the FTSE 100 index comes from outside the UK. Dividends are likely to be a relatively significant part of investor returns over the shorter-term and companies that are able to show growing dividends are likely to be well received by the stock market – medium-sized and smaller companies have continued to outperform larger companies over recent months but larger companies also look attractive with their relatively safe haven status during 'risk off' periods and exposure to overseas revenue streams, particularly helped by the weak currency.

Europe

After an excellent start to 2013, European equity markets started to falter during the latter half of the period and finished the quarter underperforming the global equity index.

Economic data within Europe has not improved and, if anything, has become slightly worse. Fourth quarter GDP, announced in February, was a very disappointing -0.6% with a surprising factor being the -0.6% fall in German GDP, which was blamed on slowing exports. Italy (-0.9%) and France (-0.3%) also suffered and the peripheral European countries, Spain, Portugal, Greece, continue to find things difficult economically.

The European political situation became increasingly cloudy during the quarter with the Italian elections in February failing to produce a decisive result with the anti-austerity vote much more popular than anticipated. At the time of writing there was still no government formed and it may require another round of elections before the situations becomes any clearer. Cyprus caused further consternation towards the end of March with the size of its banking sector relative to its own economy eventually requiring bailout assistance from the ECB and IMF. The initial terms of the bailout caused a degree of panic among investors and among small depositors within the main Cyprus banks and the terms were re-designed.

Recent events have shown that, although the ECB has pledged its support to European governments and the financial system, there are still issues to resolve in Europe. Structural reform both in core Europe and in the periphery, where unemployment remains a significant problem, still needs to happen and, although austerity is unpopular, it is the start of this reform process. At some point Europe will need to produce economic growth and it is difficult to see where this will come from in the short-term. Economic growth in Europe is likely to remain subdued with southern Europe staying in recession for much of 2013. One beacon of light is inflation, which remains below the ECB's target and is falling, which may provide some leeway for the introduction of further monetary policy.

As in the UK there are some very good, very strong companies operating from Europe with significant presence in overseas markets, so any upturn in world growth will directly benefit them and this may be a key focus for investors.

US

The US equity market benefited from the partial resolution of the fiscal cliff, which had held back performance of the US equity market relative to other markets in the final quarter of 2012, and this enabled a very strong start to the year.

Economic data suggests a continuing steady recovery, particularly in consumer-related areas with jobs data remaining strong, consumer confidence levels exceeding expectations, house prices and new homes sales also surprising on the upside and retail sales and manufacturing data showing distinct signs of improvement, helped by lower energy costs due to the shale gas / oil industry, which is becoming an increasingly important sector.

In conjunction with the improving position of the US consumer, the US banking sector is looking in a much healthier position with only one of the 18 major US banks failing very strict financial stress tests, which were based on scenarios including peak unemployment of 12.1% (current rate is 7.7%), a fall of 50% in equity prices and a fall of 20% in house prices

Economic growth is likely to remain below historical trends but the +2.2% GDP growth in 2012 was significantly ahead of the UK and Europe and there is the potential for improvement. One unknown factor is the impact of the sequestration spending cuts that went through in March without any amendments and initial estimates are that these could reduce GDP growth by 0.5% in 2013.

US companies are in a strong financial position and 2012 saw 80% of companies in the S&P 500 pay a dividend. Dividends were up 18% on the previous year and the absolute level of cash paid out by corporates reached an all-time high. Part of this will have been due to the uncertainty surrounding the fiscal cliff, spending cuts and tax rises, so with these partially resolved 2013 may see companies using their cash piles for merger and acquisition activity as has already become evident through a number of announced corporate deals. Company results announcements have been overwhelmingly positive in the first quarter with the majority beating earnings and revenue estimates. Valuations are more expensive than the UK and Europe but this is to be expected based on the evidence so far this year.

Asia and Emerging Markets

China continues to be the main influential economy within Asia and Emerging Markets and there are increasing signs that the third quarter of 2012 represented the bottom in the recent economic growth slowdown with 2012 GDP announced at +7.8%, which was the lowest level since 1999, but Q4 GDP was +7.9%, which was an increase on the third quarter figure of +7.4%. The outgoing Chinese premier re-iterated that target economic growth is 7½% per annum over the next five years and this seems to be very achievable.

The themes in Asia that are driving growth remain in place, namely the expanding population and the rise of the middle class consumer. The Chinese economy will still have to make the, perhaps gradual, transition from an export-orientated, manufacturing economy to a consumer-orientated, domestically driven economy. Asian economies have strong domestic growth potential and this has partly insulated them from the worst of the western economic problems but this transition will also have an effect on China's regional trade partners.

Elsewhere, interest rate cuts were made by Australia and Mexico. In the former's case this was to stimulate growth from an economy that has direct trade links to China and is a large exporter of raw materials to their manufacturing sector. In Mexico's case the economy has been performing well and inflation has fallen to a sufficient level to allow an interest rate cut. Brazil's economy has suffered a significant slowdown recently culminating in GDP growth of just +0.9% for 2012 as a whole including +0.6% annualised for the final quarter but stubbornly high inflation is making it more difficult for the policy makers to adopt more pro-growth policies. The Russian market has also had a very difficult 12 months but policies have been introduced recently to open up both their fixed income and equity markets, which may attract more foreign investors and also provide more opportunities for domestic investors.

Asian and Emerging market equities have lagged over the last few months and there are signs of economic slowdown in many countries. Each region and economy is different but a number of policies are being used to stimulate growth and China continues to be in a relatively strong position. Current valuations may represent a good entry point for the longer-term investor.

Japan

Everything seems to have changed in Japan and yet, economically, nothing has changed at all. The equity market has gone through a significant rally over the last six months due to investor optimism about the policies that the new Prime Minister Abe may introduce to stimulate both growth and inflation. What may be different to previous episodes like this is that Abe's party is likely to gain majority representation with the relevant political establishments and that he will have the support of the new governor of the Bank of Japan, Kuroda. Together they can implement policies that will help meet the new 2% inflation target.

What has yet to be announced is exactly what those policies are. They are likely to involve monetary stimulus, quantitative easing and other measures but these would need to be on a much larger scale than previously to have any effect. Japan has been entrenched in deflation for well over 20 years and this is not something that is easily reversed.

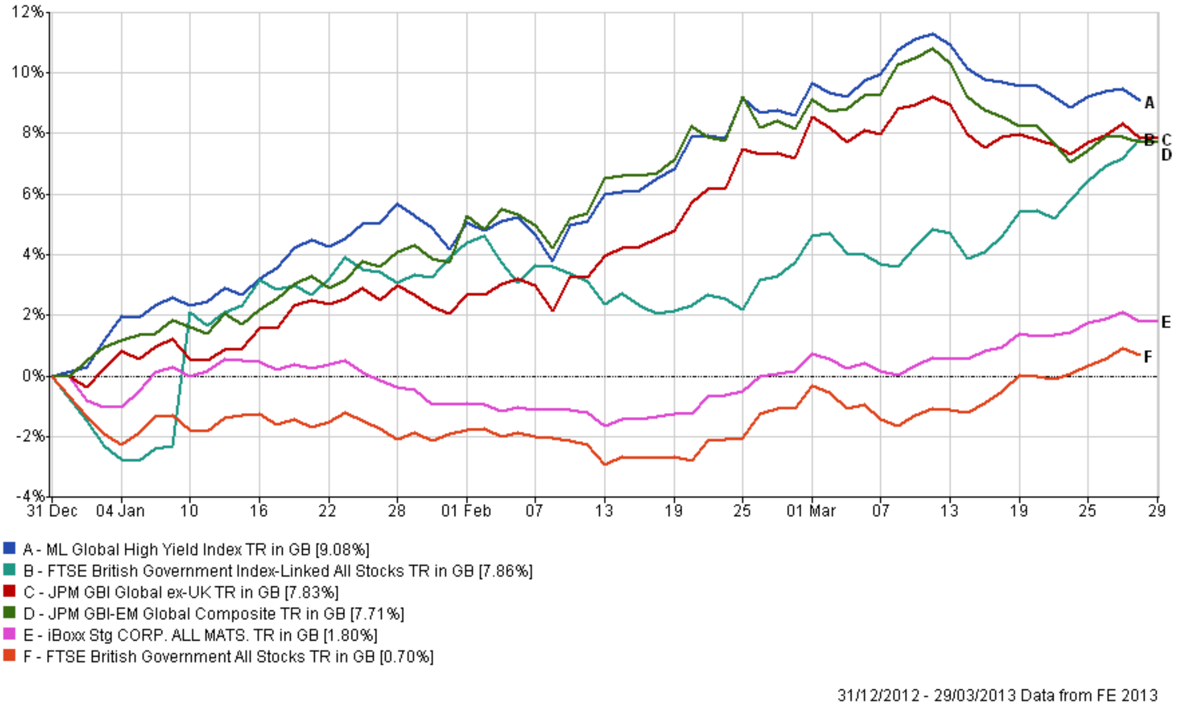
The amount of government debt currently outstanding is another issue in this area. Whilst deflation is in the system interest rates will remain low making the debt servicing relatively easy but any hint of inflation coming through may lead to higher interest rates and higher debt servicing costs. It will be interesting to see how this is tackled should it occur.

Japan still holds some of the world's largest companies and brands and one consequence of Abe's rhetoric has been a significant weakening of the Japanese yen relative to other major currencies, namely the US dollar but also the euro and the pound. This has benefited those large companies with significant profits from overseas markets but has led to lower stock market returns for overseas investors unless they hedged the currency. Developments over the next few months will be very interesting and could be very beneficial for Japanese equities, which are cheap on a number of historical measures and may continue to be the surprise package in 2013.

Fixed Interest

Chart showing 2012 returns for major fixed income indices:

Chart showing Quarter One returns for major fixed income indices:



Despite the strong returns from equity markets, which have historically been negatively correlated to fixed income markets, the weak global economic environment has led to relative stability within the fixed income asset class. The relatively strong financial position of global companies and investors' demand for yield has led to continued outperformance from high yield but, as can be seen from the chart above, both this and emerging market debt fell from mid-March onwards, in line with global equity markets.

By contrast, the UK gilt market went through a relatively difficult time until the time of the Budget, at which point yields fell on the announcement of reduced economic growth forecasts. As corporate bonds have some correlation with government bonds, and they have performed well over recent months, they also suffered to some degree during the quarter but rallied slightly towards quarter-end.

UK index-linked bonds performed well, particularly during March, as UK inflation remained sticky and break-even rates rose to their highest level since September 2008 in mid-March.

With global economic growth likely to be below trend for some time and below trend in a number of economies, such as the UK and Europe, the policies to stimulate growth whilst keeping control of debt levels and financing costs will be closely scrutinised. Quantitative Easing (QE) will continue to play a big part in this process with three of the Bank of England members voting for more QE at each of the last two monthly meetings, inflation in Europe falling below target to a point where further monetary easing is becoming a distinct possibility and the new Japanese Prime Minister and new governor of the Bank of Japan strongly hinting at the introduction of quite radical monetary policy. The possible exception is the US where, although QE is continuing through the monthly purchase of US Treasuries and mortgage-backed securities, there are hints that it may be reduced at some point in the coming months, as economic growth continues to be relatively strong. Some commentators are concerned that QE will lead to a pick-up in inflation but the usual drivers of inflation, particularly wage growth, remain absent meaning that the normal upward price pressures are not there.

Government bond yields are highly unlikely to rise quickly, as the major central banks have stated rates will not be rising soon, and the asset class will continue to be a relative safe haven during times of economic stress. That said, the current yield levels, particularly in the major developed bond markets of the UK, US, Central Europe and Japan, mean that total returns over the next few years will be much lower than the recent past.

The extra yield available from investment grade corporate bonds over government bonds remains relatively attractive but, just like government bonds, the asset class has produced strong returns over the last few years and current yield levels suggest returns are likely to be much lower going forward.

Over the shorter-term high yield corporate bonds and emerging market debt are likely to remain popular with yield-hungry investors with the risk-on / risk-off environment an important determinant of returns. Over the longer-term fundamentals are likely to be the main driver of returns from these asset classes, with the key indicators being economic growth rates and financial stability within emerging markets and the financial health of corporates.

Property

Very little has changed within the UK commercial property market over the last 6 to 12 months with London and the South East remaining the strongest performing regions, prime property assets outperforming secondary property assets, income being the main performance driver and retail assets underperforming the other main property sectors.

The yield available on the UK commercial property market remains significantly above that of cash and UK gilts but the transaction costs involved in property purchase mean that the yield to the end investor is typically much lower than that of the market. With UK economic growth remaining under pressure, commercial property capital values may continue to fall with the retail sector likely to continue to struggle the most, particularly high street retail. Rental growth is also expected to remain weak and the availability of debt for property purchase is reducing, particularly from traditional lending sources.

Although overall investment activity is weak, London continues to attract significant investment levels with approximately £14bn invested into the commercial property market during 2012 with approximately two-thirds coming from overseas buyers.

Most direct property funds hold reasonable levels of residual cash which makes keeping up with the IPD index difficult in this environment but this is needed to support the liquidity required in the current volatile investment environment.

Summary

2013 has started very well for equity investors with most of the major markets producing double-digit, or just under, returns, with the exception of emerging markets. There are continuing economic concerns, particularly within the UK and Europe, as highlighted by recent developments in Cyprus, but the strength of the US economy and improving data from China has helped to alleviate some of these concerns. The impact of the recent US tax rises has yet to become apparent and the US debt ceiling has not been formally resolved but it has been foolish to bet against the US consumer in the past and the Federal Reserve is ready to act and add more stimulus if deemed necessary.

Although global markets have undergone a re-rating they continue to be reasonably attractively valued, particularly relative to the major government bond markets. Dividend yields and the potential for dividend growth are proving attractive for yield-seeking investors but we would like to see corporate earnings coming through to provide some further support to current valuations. We expect equity markets to remain relatively volatile with periods of risk on and risk off, so a balanced approach to equity investing remains appropriate. Correlation between stocks and sectors is beginning to come down and this should provide a better environment for active stock selection.

Yields have been rising gradually within 'safe haven' government bonds and they may continue to do so should the economic environment continue improving, although increases are likely to be small and happen slowly. Increasing government bond yields may have a knock-on effect to corporate bond yields but the extra yield available (spread) over government bonds for investment grade, high yield and emerging market debt should see continued support for these asset classes despite the headline yields being low relative to historical averages.

Ken Rayner, Director, Rayner Spencer Mills. April 2013