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Quarterly Investment Bulletin

July 2013

General Economic Overview – Quarter Two 2013

The second quarter of the year has shown us that markets can rally for a considerable length of time if the belief is that they are supported by the strongest of fiscal forces such as the central banks of Europe and the US. Equally if this support is seen as wavering in any way then we can also see how quickly the positive sentiment can be taken away. Until the end of the quarter the momentum that was driving markets forward was the predominant force in pushing valuations ever higher until the very last weeks in June when we saw some volatility return following the statements made by the Federal reserve Chairman Ben Bernanke. In actual fact he simply stated the obvious; that if US growth was strong enough and employment high enough then a tapering of the asset buying programme would be considered. This was not new news but enough to spook markets taking some of the froth off the recent gains.

Fundamentally, little has changed during the quarter as companies (with some exceptions) continue to deliver robust earnings figures. Data has been good over the quarter in those economies that have started to see some growth. The stand out economy has clearly been the US where data on employment and GDP growth has been strongest. We have also seen other regimes try to improve the pace of change, in particular in Japan where President Abe has been aiming to generate inflation by injecting huge financial stimulus into the Japanese economy. We have also seen the opposite in Asia where Chinese growth has come under scrutiny and a much lower level of growth than in the last ten years is now expected. This has been part of the reason for the bigger sell off in Asia which has been seen to be supported by western financial stimulus as well as the commodity super cycle. The consensus now is that this cycle has come to end, as the new Chinese government focuses on domestic growth, controlling the housing boom and fixing the local banking system, which is seen to be creating internal credit problems in the region. This combination of slowing Chinese Growth and the reduction of QE has shaken the faith of investors in the region.

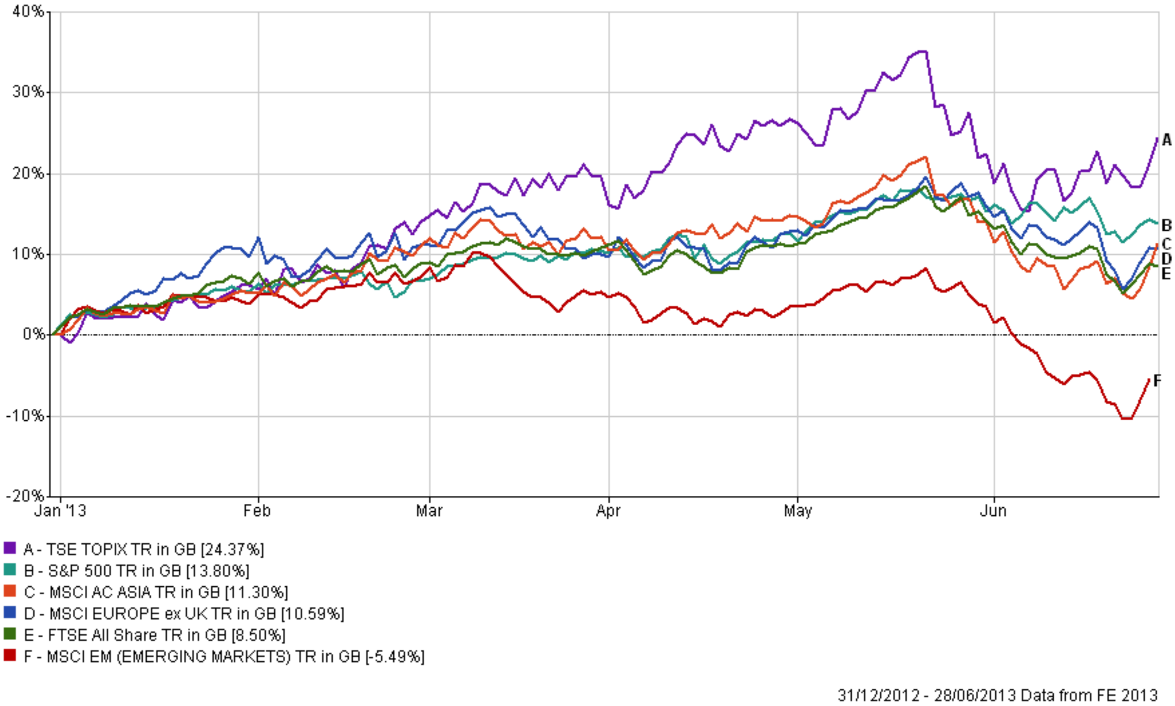
The problems in Europe, which dominated headlines for much of the previous two to three years, has for once been relatively quiet in this quarter. The problems are still deep rooted, particularly in the peripheral countries, but the ECB support statement last year seems to have calmed investors nerves in 2013. The focus has moved to forthcoming elections in Germany, which remains the economic hub of Europe and once this has been resolved we may start to see more progress on outstanding financial and unification issues.

In fixed interest markets we have seen sell offs in May and in later June as fears of reducing central bank support, potential interest rate rises and inflation have caused yields to rise. There is still much support in bond markets however and managers do not expect to see significant rotations by investors for some time yet.

Despite the more recent market falls and increased volatility the year has been a positive one in terms of market returns, company fortitude and earnings progression. Some managers are now taking a more positive stance on growth believing core western economies are in better health than the current batch of statistics are telling us, so there may be more optimism or upside surprise than the current situation suggests. It would however be a little premature to get too carried away.

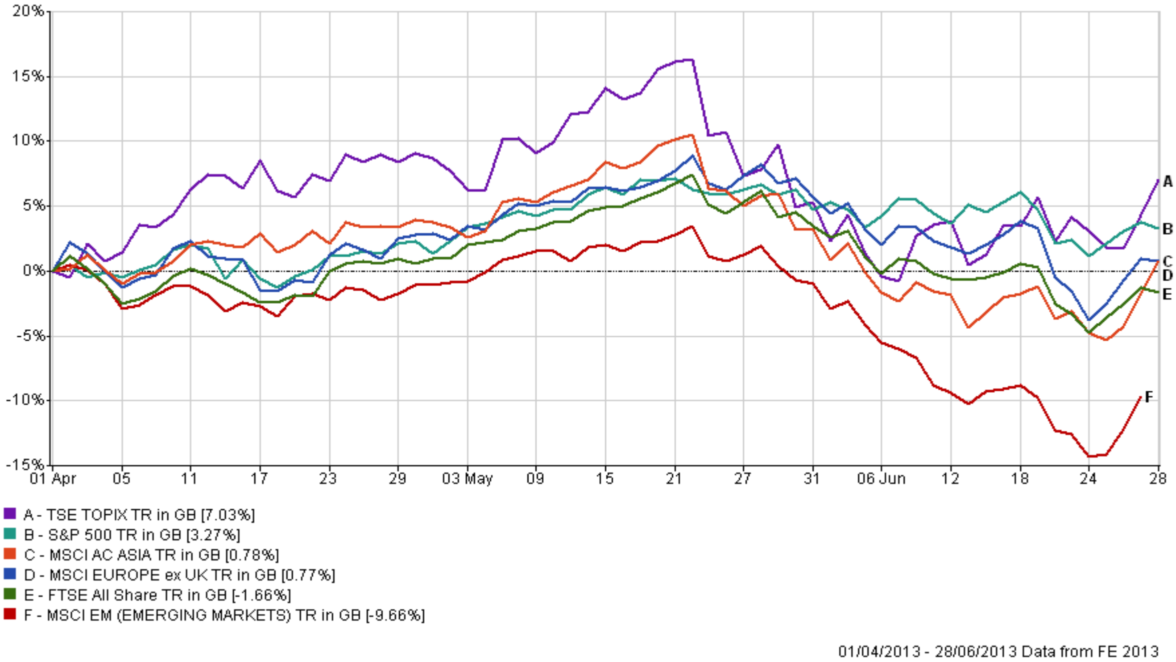
Equity Markets Overview

Chart showing 2013 returns for major market indices:



Equity markets have continued to show growth in 2013 despite the recent falls in markets with the exception of the emerging markets.

Chart showing Quarter Two returns for major market indices:



Markets have seen a more volatile ride in the last quarter particularly since May when both bonds and equities have seen threats to stability give rise to sell offs across the globe. For once western markets have survived the threat more robustly than Asian ones but this has been a reflection of a number of factors not least the threat of a loss of QE stimulus from the Federal Reserve.

Recent volatility in markets has occurred as investors are concerned about the pace and speed of an end to American QE. As long as this ends for the right reasons - a pick-up in economic activity - the prospects for equity markets over the medium terms should remain positive. Even in the US interest rates will rise only slowly, whereas in the UK and Europe rate rises seem highly unlikely in the next couple of years. Overall the background for risk assets remains favourable.

The strongest performing markets have been in the west, but also include Japan thanks to the recent bout of stimulus supported by foreign investors. This is illustrated quite clearly in the charts above.

Sector Review

UK

The UK has had a surprise reprieve in the last days of the quarter as an update of the data has shown that the country did not fall into a double dip recession in 2012 as first thought. Although this is positive news the actual level of growth at 0.2% is not really significant enough to consider that the economy is therefore on a solid growth path once again. There has been some encouraging data in that employment has continued to be strong, not reaching the levels seen in the most recent recessions. There have also been small signs that the UK economy may start to gradually improve from current growth levels, although growth is expected to remain well below trend. Q1 GDP has been confirmed to be the same as the original estimate of 0.3% and the Bank of England actually increased their GDP forecast for 2013 from 0.9% to 1.1%. The British Chamber of Commerce also increased their 2013 GDP forecast from 0.6% to 0.9%. The National Institute for Economic and Social Research also estimated that GDP for the 3 months to the end of April was 0.8%.

The government has continued with most of its cost cutting or austerity plans although they have introduced support for the housing market through the ‘Help to Buy’ equity loan scheme, which has proven to be successful in stimulating the bottom end of the housing market. The IMF and other economic commentators have suggested more stimulus is needed to push growth ahead and the new Bank of England Governor may well signal new policies in this area. Some investment managers have indicated to us that they feel the UK is in a stronger position than the current GDP forecasts predict and that UK companies are stronger than first thought in having ridden through the worst of the crisis.

Europe

Europe has had a mixed quarter. For once not at the centre of investors thoughts, the market has had (until recently) one of it more successful periods as valuations caught up with some other western markets in the core areas. Outside of the core much of the Eurozone remains in recession with growth prospects continuing to be downgraded. Low levels of economic activity together with continuing high unemployment remain a significant headwind in peripheral Europe. Credit availability to SMEs in the periphery remains challenging with companies paying significantly higher rates for bank credit than in core countries such as Germany.

Within peripheral Europe the monetary transmission system is not working, so, not only is access to credit hard, borrowing costs have not fallen in line with the declines in sovereign bond yields from their crisis levels in 2012. For example in Italy small businesses typically face interest costs of 10%, twice the rate that companies in Austria get charged for credit.

The most positive outcome to this scenario is if the ECB try and find ways of reducing the real level of interest rates for businesses in peripheral Europe. Cuts in interest rates can only stimulate demand in recession hit economies if there is an effective transmission programme for monetary policy - further measures from the ECB that attempt to lower real borrowing costs for companies may be seen.

There have however been some small snippets of good news. The IMF announced that they expect fiscal tightening of just another 0.2% of GDP up to 2016, which compares to fiscal tightening of 3.5% of GDP over the previous 3 years and that Spain and Italy may be in a position to loosen policy in the next few years. Also, after the European Commission evaluated all 27 EU members budget plans they extended the deadline for France and Spain to bring their budget deficit down to 3% of GDP by 2 years and the Netherlands and Belgium were given an extra year. They did warn however that reforms, primarily labour reforms, are taking longer than desirable. This is important given the current levels of unemployment with the region's rate up to 12.1%, Spain's rate up to 27.2%, French jobless claims reaching a record level and the Eurozone private sector shrinking for the 15th consecutive month in April, although Ireland's unemployment level has fallen below 14% for the first time since 2010.

US

The strongest economy has gradually got stronger in the quarter as data and company confidence indicators all improved. Employment data also got stronger although it has yet to prove conclusive to those in the central bank as some data has wavered in recent months. This improvement has led to one unintended consequence which rocked markets at the end of the quarter. The statement by the Fed that asset purchases would be tapered if economic conditions continued to improve should not have been a shock to investors but it seemed to have a more than anticipated negative effect. In actual fact the Federal Reserve is likely to welcome the combination of rising stocks and bond yields as a sign markets are optimistic that its policies are delivering a sustainable improvement in the US economy.

The US economy continues to perform well relative to the other major developed economies, although Q1 GDP was revised down to an annualised 1.8%, and household consumption remains strong (April's figure was surprisingly weak falling -0.2%, the first fall in 12 months, but May's consumer confidence figure rose to 76.2 from 71.2 in April). Business spending was weak and government spending cuts had an impact. Employment figures continue to be mainly positive with 165,000 jobs added in April (non-farm payroll data), which was higher than expected, both February's and March's figures were revised upwards and jobless claims were at their lowest level since January 2008. Combined with house prices up 10.9% in March from a year earlier this is helping the 'wealth effect', which is reflected in April's retail sales, which were up 0.1% versus an expected fall of 0.3%.

The full impact of the sequestration cuts on the US economy will not be known for some months but there seems to be evidence that they have affected some areas of the economy over the short-term with consumer confidence levels perhaps the most noteworthy.

Equity investors seem to see the US stock market as a relatively safe haven given the continued global economic uncertainty, the relatively attractive valuation of the equity asset class but also the improvement in the US economy. The figures are much stronger than other developed Western economies and the US is usually one of the first economies to emerge from recessionary conditions. US-listed companies continue to be very cash generative and there are signs that merger and acquisition activity is picking up.

Asia and Emerging Markets

This is arguably the most difficult area to evaluate at the moment, due to the threat of Chinese slowing and a future reduction in QE on the horizon, which has been seen as a negative for the region as a whole. Conversely it is also potentially a buying opportunity as the sell- off has been quite severe and Asian economies are very strong financially and at a company level have continued to be profitable. China is at the centre of the debate and clearly controls much of the growth in the region so it is not surprising that any reduction in this growth will cause repercussions economically. The change in leadership has meant a re-focus on the domestic economy and the improvement in housing and general living standards for all. The shadow banking crisis has been much publicised but it is being slowly resolved with corruption and ostentatious wealth being cracked down upon. The Chinese economy is still growing however and government finances are extremely strong giving them the ability to face any future local financial issues with confidence.

Emerging markets have underperformed in the second quarter. Increases in the spread between emerging market and US debt provided a more difficult backdrop for stocks. Some of the worst sufferers have been commodity producing countries where low resource prices have impacted negatively.

India continues to suffer from the slow pace of reform with economic growth falling to 5%. In contrast the economies of the ASEAN region continue to perform strongly as an underdeveloped consumer sector plays catch up with its neighbours. Economic fundamentals and demographics remain broadly favourable in the ASEAN countries. .

Japan

In Japan the new administration led by Premier Abe has resulted in quantitative easing on a scale never seen before. The bond buying programme announced by the Bank of Japan is similar in absolute size to the US Federal Reserve but is taking place in an economy under half the size of the United States. With printing of money on such a massive scale it is no surprise that the value of the Yen has gone considerably lower. This not only has implications for the Japanese economy, but also for Japan's Asian competitors - Korea in particular has been hard hit.

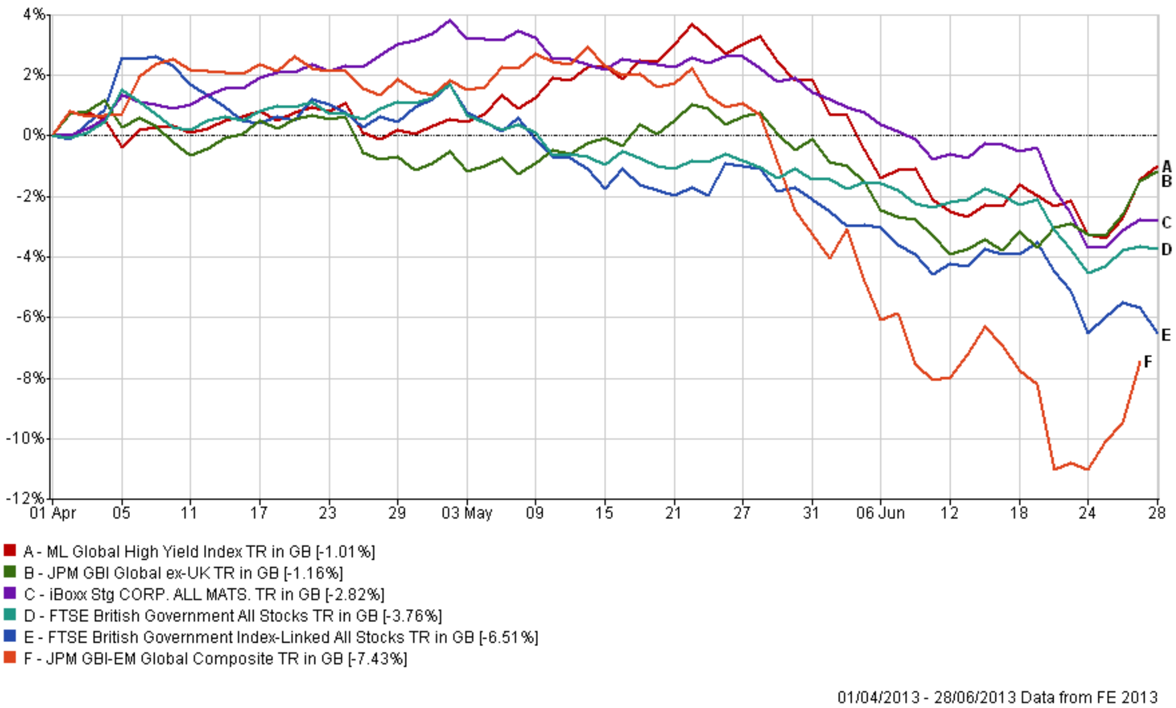
It is however still very early days for the overall 'Abenomics' strategy (aggressive monetary easing, flexible fiscal policies and economic growth strategies) with the main impact at present being on the currency, but the Q1 GDP is encouraging, providing potential evidence that policies are translating into economic growth. The level of government debt continues to be a major concern, although interest rates currently remain at very low levels. Japan should be able to service this debt for some time without any major issues provided that bond yields do not rise significantly, which they may do if evidence of inflation starts to appear. Despite the market rally over the last 6-9 months, longer-term valuations continue to look attractive (particularly with the recent falls) versus historical measures, although how long the rally lasts may depend on how long foreign investor sentiment remains positive towards the recent political developments and whether there are further signs that the new government can lead Japan out of its current economic slump.

While the market had reacted favourably to this move, there is now a realisation that longer term printing money on this scale in an economy where debt to GDP is already 240% is a high risk policy. Japan needs structural reform to take on its challenges of poor demographics and low productivity head on. Evidence of real reform coming through may be necessary to see a further significant lag upwards in the Japanese equity market.

Fixed Interest

Chart showing 2012 returns for major fixed income indices:

Chart showing Quarter Two returns for major fixed income indices:



Fixed interest markets have been in a state of uncertainty for some time. Most investors know that if we see more global growth then stimulus will stop and gradually we will see interest rate rises and eventually inflation. The problem is that this may well be some way off and with the requirements of many institutional and pension liabilities the support of the market remains underpinned. The sell offs in May and June saw rates rise and investors lose capital but it was not a full rotation in equity assets as some investors predicted. Real rates of return in the UK are negative and equity yields still outstrip bond yields in many cases so the picture for this market remains confusing.

Many investors have moved to being short of duration to protect against the potential future threat of interest rate rises but this is a difficult strategy to get right in volatile environments. A more flexible strategy with a global perspective looks to offer more options in this environment.

Fixed interest assets classes across the board saw a sell off in May / June. This included government debt, credit and emerging market bonds. Emerging market currencies also suffered setbacks as concerns rose over the loss of competitiveness of some developing economies after the significant depreciation of the Japanese Yen.

Over the longer-term we would still expect yields to rise gradually and, given, the very low yield levels, this will lead to very low levels of total return. The spreads of investment grade, high yield and emerging market debt over government bonds is reflective of the superior corporate financial strength and the relative financial strength of emerging economies versus developed economies. Investors continue to question whether or not this outperformance relative to government bonds is sustainable but this extra yield is attractive in an environment where a decent level of yield is relatively difficult to find. It may be that the yield forms a much bigger part of the overall return to the end investor and provides a cushion during more difficult times for the asset class. Emerging market debt is likely to continue being volatile in the current economic environment but emerging economies are in a relatively strong position versus developed economies, as a group their credit ratings are continuing to improve and most countries have current account surpluses and foreign exchange reserves to help stimulate the economy when necessary. A continued concern about the 'higher risk' markets at the moment is liquidity and the ability of managers to buy and sell stocks in the market given the pull back by investment banks from this area of business.

Property

Although little has changed in this area, we have seen signs of late of investors looking to property to offer some diversification when adding risk to portfolios.

The market characteristics are still very much the same however in the UK with the South East and London in particular having greater strength than the rest of the UK. There has been some debate on whether London is in a bubble of global investment but there seems little evidence of the demand subsiding at both commercial and residential levels.

For any property fund in this sector it is difficult to see significant reasons to be outside of the south of England in terms of retail assets but a well- managed portfolio that improves its stock and invests in the future will have fewer voids and be more profitable for its investors through these difficult times. These are the funds to look for when investing.

Summary

The quarter has continued to deliver growth in equity markets and some of the economies that were showing more encouraging signs of growth have consolidated this, such as the US and Germany. There have, however, been set-backs towards the end of the quarter due to the latest interpretation of quantitative easing policy by the Federal Reserve.

Whilst it is unsurprising that concern over a slowdown in Fed policy should result in more volatile equity markets, the impact if the US economy is entering into a period of self-sustaining recovery may not be that protracted. Even with a slowdown in asset purchasing, in general Central Banks worldwide continue to provide ample liquidity for the favourable back drop for risk assets to remain. Furthermore, traditional factors which have pushed inflation higher in the past remain absent. Therefore, monetary tightening with the purpose of slowing economic growth and lowering inflation still seems a considerable way off.

Governments around the world are likely to continue to maintain close to zero interest rate policies to enable the real level of debt to be eroded and they continue to be able to issue short dated government bonds below the rate of inflation helping their longer term fiscal position. The US economy seems the one most likely to see a slowdown in QE. This is likely to be positive for the US Dollar over the medium term. Gold and commodities traditionally have a negative correlation with the US currency and levels of fixed asset investment and infrastructure spending in China continue to ease meaning the short term outlook for many commodities will remain difficult.

Perhaps the largest potential change is for the fixed interest market which has been anticipating a transition to risk assets for several quarters given current yield levels and the potential of future inflation and interest rate rises. At the moment these pressures seem to be some way off but any signs of improving growth stronger employment figures could see more volatility in the bond market.

The bond market, both sovereign and corporate, remains well supported although yields have gone up since the threat to QE was muted by the FED. We think it is unlikely interest rates will rise in the near future in the west given the fragile nature of the recovery and housing market instability. There are still areas of the bond market that offer opportunities but it is often in higher risk areas, which are not attractive to many mainstream investors.

Global economic growth is in a stronger position but because we remain in what is a financial experiment where central banks have propped up the financial system the long term outcomes are very uncertain particularly when such props are taken away.

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July 2013