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Quarterly Investment Bulletin

October 2013

General Economic Overview – Quarter Three 2013

The main topic of debate this quarter has been that of determining the real level of economic growth in each of the leading economies. In the US this debate has centred on the likelihood of QE tapering, and in China on the concerns over a hard or soft landing as the growth rate of the economy slows. In Europe the focus remains on the peripheral nations and their ability to stabilise debt and deliver on austerity measures.

As is generally the case over the summer, the markets have generally fluctuated around the same sort of levels as politicians and senior investors are on holiday. In the US most of the issues have revolved around the variability of economic data and of course the likelihood of the Federal Reserve switching off the monetary tap of Quantitative Easing. In Europe, the German elections were a distraction as progression of anything meaningful awaited the result.

As we head into the fourth quarter of the year investors need to decide whether the strong performance recorded in most equity markets so far in 2013 is likely to continue. There are three issues that are likely to determine the performance of equity markets over the remainder of the year.

The first of these is how dependent the US and global markets are on the accommodative monetary policy of the US Federal Reserve. In other words, if quantitative easing (QE) is moderated through tapering can equity markets continue to deliver gains to investors?

The second issue is whether the European crisis could re-surface in some form after the German elections. For the peripheral economies there has only been marginal improvement with unemployment, especially amongst the young, remaining exceptionally high. For most of the peripheral European countries there is no meaningful economic recovery and debt ratios remain high as support for austerity is waning both amongst politicians and the electorate.

The third issue for investors is whether China can smoothly adjust to a slower rate of growth, as it tackles an unhealthy level of credit expansion and looks to rebalance its economy away from fixed asset investment (FAI) to a more consumption led economy. This will have implications for the global economy as well as emerging markets and commodity producers.

Much of the activity in the quarter has been influenced by the views on Quantitative Easing and the position of the Federal Reserve. In May and June of this year when Fed Chairman Bernanke first suggested the prospect of potentially moderating the bond buying programme (commonly referred to as tapering) markets suffered a bout of volatility. Even though this was a change to domestic US monetary conditions, its impact on global markets was far reaching. Riskier assets in fixed interest markets initially suffered a sharp selloff and whilst the high yield markets have recovered to some degree, until recently, emerging market debt has continued to suffer as outflows from the region have weakened local currencies. Emerging market equities also suffered a selloff, although prospects for individual countries and regions are now quite differentiated.

Some investors argue equities have only risen due to Fed largess on monetary policy. In other words equities have risen higher on a tide of Fed generated liquidity and so any withdrawal of this will be bad news for stock markets. While in the short term it would be foolish to argue volatility is unlikely to occur, more important over the medium term is whether Fed tapering has any impact on economic or market fundamentals.

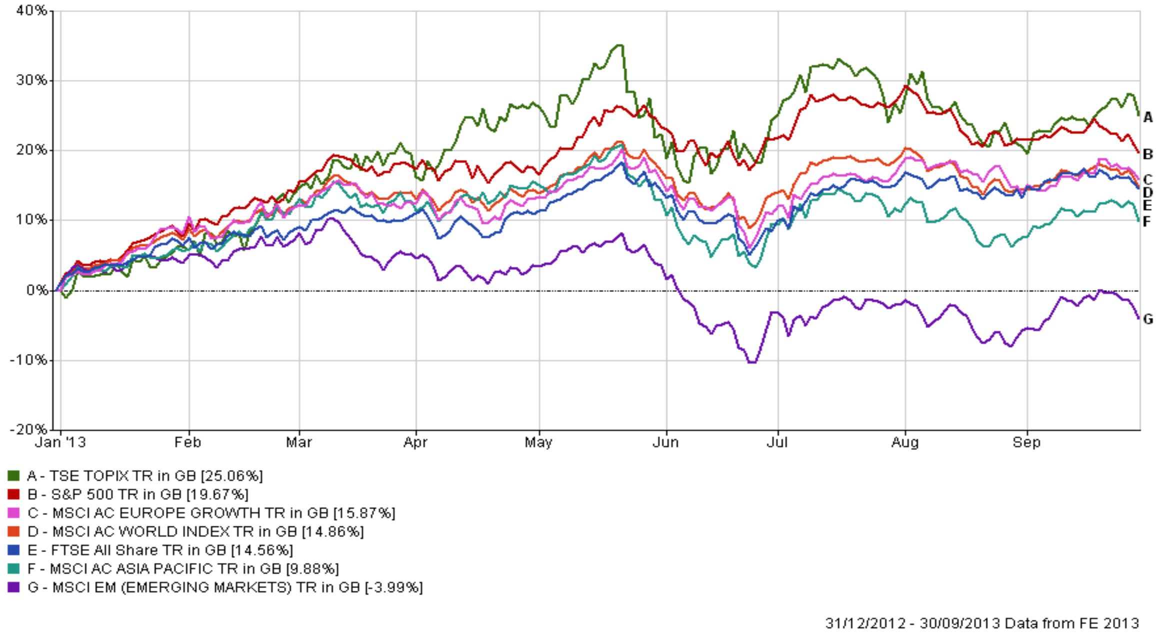
The difficulty for the monetary authorities was seen in the when tapering was first suggested - whilst seen as an action that was inevitable, markets still seemed to over react. In September we then saw the central bank surprise everybody by announcing tapering was still some way off which reversed some of the movements in markets and lowered bond yields once again.

We remain cautious on this issue as an orderly withdrawal of QE looks difficult given the economic fragility that still exists despite growth figures improving in a number of economies around the world. It is likely that whenever it does come it will create volatility and cause issues in fixed income markets as yields start to rise again.

Although tapering still hangs like a cloud over markets, overall there are a lot of positives in company information flows as well as in employment and economic confidence numbers in a number of developed economies including the UK although this growth level is expected to be muted given the severity of the financial crisis that preceded it. This shows the global economy is in a stronger position to improve growth and fight off the deflationary pressures that still exist.

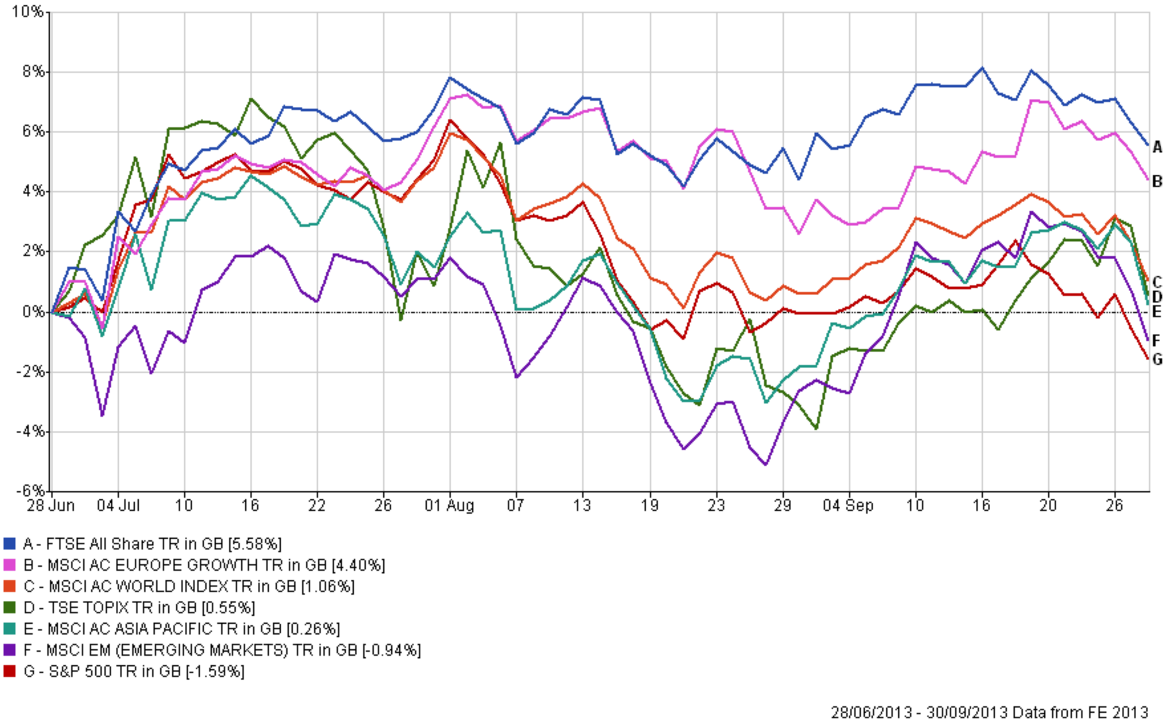
Equity Markets Overview

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 Three returns for major market indices:



The focus of much of the quarter has been on sentiment surrounding the potential for central banks to reduce quantitative easing in particular in the US. Markets have risen overall during the third quarter but it has been a rollercoaster ride, as following a strong July we had a weak August and then a stronger September (although markets fell in the final days as issues arose surrounding the US debt ceiling and budget and a further Italian political crisis). Developed markets seemed to continue to fare better than Asian and Emerging Markets even with the announcement by the Fed at the end of September that they would not be tapering in the near future. The strongest market was the UK in sterling terms with the US and Europe also seeing good results based on stronger economic data. In valuation terms Europe and Emerging Markets seem to have the best value but they also have structural issues to overcome providing greater uncertainty.

Sector Review

UK

The UK economy was already showing more concrete signs of economic recovery when Mark Carney became Governor of the Bank of England with the supposed remit of delivering an even easier monetary stance. Whilst Carney has been at pains to emphasise that rates will remain low for a considerable period, markets believe that the more definitive signs of economic recovery will result in interest rates having to rise. Overall the signs on the UK economy remain positive with manufacturing showing a revival.

Economic data continues to surprise to the upside, including an upgrade to the second quarter figure to 0.7%. This led to increases in GDP forecasts from the National Institute for Economic and Social Research, who raised their 2013 forecast from 0.9% to 1.2% and their 2014 forecast from 1.5% to

1.8%, and the British Chamber of Commerce, who increased their 2013 forecast from 0.9% to 1.3%, their 2014 forecast from 1.9% to 2.2% and their 2015 forecast from 2.4% to 2.5%. The Bank of England also upgraded their growth forecasts, increasing 2013 to 1.4% and 2014 to 2.5%.

The governments help to buy scheme has turned out to be more help to sell, but has resulted in increased levels of activity in the UK housing market. This is likely, as occurred in the States, to have a multiplier effect throughout the economy, increasing consumer confidence and spending. Whilst longer term there is always a risk of a further bubble in the UK housing market, this is some way off. The property market in London remains vastly different from the rest of the country, reflecting a trend of extremely high prices in the world's leading mega cities. At this stage the UK economy seems much better placed to achieve escape velocity and a self-sustaining economic recovery.

Europe

Economic indicators in Europe have turned more positive in recent months, for example business confidence indicators are now the best we've seen in the last couple of years. PMI surveys are now indicating expansion, especially in the core economies. Whilst this on the face of it is good news, Europe's debt crisis has yet to be solved.

In many peripheral economies economic activity continues to fall and for some there is worsening debt to GDP ratios, because austerity reduces government revenue as well as expenditure. With economic contraction continuing in some countries, and unemployment, especially youth unemployment, remaining high political support for the austerity programme is breaking down in some places. Hopefully the Fed will be aware of the potential impact of a rise in US bond yields on the peripheral economies in Europe and therefore the global economy.

At some stage following the elections, Europe needs to come up with a longer term solution to the problems in the peripheral countries to give them any prospect of breaking free from years of economic stagnation. Even in Ireland, the best example of effective austerity and economic reform, the economy has slipped in and out of recession as higher indirect taxes continue to negatively impact the consumer. Over the medium term there needs to be closer fiscal and financial integration within the euro zone or some countries are likely to leave. Either way, some form of debt forgiveness seems likely to occur.

Once countries reach a primary surplus (i.e. the government is in surplus before it pays interest on its debt) then Eurozone exit becomes possible - until this position is achieved any unilateral exit of the euro zone would result in countries not being able to meet social welfare payments. Italy has now moved to this position and during the last election some political parties floated the idea that remaining within the euro was not a given. Again, history shows that the way most countries have successfully escaped huge debt burdens has been through de-valuation of the currency which is only possible if they leave the euro. At some stage politicians will have to face up to the huge issues being created by intolerable levels of youth unemployment.

Following the elections, Germany is likely to come under pressure to choose between maintaining the euro so as to sustain export competitiveness (accepting that there will be a cost involving fiscal transfers from the strong economies to the weak) or risking a euro break up. The latter would have negative implications for Germany's export heavy economy and there would also be a risk of write downs on its holdings of peripheral debt to the detriment of German tax payers. In the short term Germany is likely to be more accommodative in softening its stance on austerity on the basis that reforms have and will continue to take place in peripheral countries. Whether it moves quickly enough to allow a significant recovery in economies suffering from austerity fatigue remains to be seen.

The actions of the ECB will also be important, especially in an environment of Fed tapering. Under Draghi the ECB has been much more aware of market sentiment and is likely to take steps to ensure funding costs, especially in the periphery, do not rise significantly. Europe seems likely to see the current low level of interest rates for many years to come.

In valuation terms the European markets alongside emerging markets look to be a good long term option but this will only be proven if the economies in the periphery can improve.

US

The economic recovery in the States has been stronger than in other developed countries, but it remains relatively muted compared to previous periods of recovery. The labour market still has a long way to go before unemployment reaches a level of 6.5%, especially as an expanding US economy may encourage workers to re-enter the labour market. One effect of the tapering talk has been an increase in mortgage rates which are priced off US treasuries. This could impact on consumer spending and also the housing recovery which has been an important multiplier within the US economy. Even in the States real incomes remain under pressure, with many of the recent employment gains being in low paid part time jobs. The upcoming impact of Obamacare will see more people having to pay for health insurance, which in the short term acts like a tax on income.

One of the most important things for investors to remember is that there is a distinction between actual monetary tightening when interest rates are raised, and the likely actions of the Fed. Tapering, when it occurs, will only moderate monetary stimulus which is just putting less pressure on the accelerator rather than putting a foot on the brake. Official short term rates in the States will continue to remain low for an extended period of time so, although the US equity market may see a wobble when tapering is announced, this is unlikely to be long lasting if economic fundamentals continue to improve.

Markets have rallied over the last 12 months anticipating an improvement in global economic fundamentals due to easy monetary conditions which has resulted in equity valuations now being on the cheap side of fair value, rather than the extremely cheap levels of a couple of a years ago. Even if bond yields rise, the current earnings yield on the US market (the inverse of the PE ratio), still looks high relative to 10 year bond yields in the States of under 3%. Equities would face a much more difficult challenge if bond yields were moving higher in response to rising inflation rather than higher economic activity - bonds do not look likely to suffer from an inflationary threat over the remainder of the year.

Clearly resolution of the issues surrounding the debt ceiling and agreement on the Budget will need to be resolved in early October if we are to maintain stability in markets.

Asia and Emerging Markets

Our Asian commentary is as usual dominated by the activity and growth rates in China which is the economic barometer of the region.

The recent threat of tapering in the US had far reaching effects in Emerging Market stock market values as they are seen as one of the significant beneficiaries of the increased flows of capital created by quantitative easing. Although many emerging markets have better GDP to debt ratios than the developed world they have more sensitive and volatile stock markets. This has been illustrated in the recent quarter when they have underperformed most western markets.

It is now clear that economic growth in China is slowing and that this has been recognised by the Chinese authorities. The growth model in China is based on exports and investment has long been recognised as unsustainable over the longer term and the new leadership appear to have recognised this. As a result, any hopes of a 2009 type stimulus package to the slow down have quickly been dashed. There is also evidence that financial stress within the country, primarily related to off balance sheet lending and credit expansion, has increased. Clearly the new government in China faces challenges in managing this period of transition and whilst there is the potential for an economic hard landing, the most recent data such as PMI Indices demonstrate a stabilisation in the economy with the data once again showing an expansion in manufacturing and service activity. The government has also indicated it will take action if economic growth slips below a lower limit, probably around the 7% level. In China the government is looking to underwrite growth, but through fiscal policy rather than the monetary policy used by the Fed in the States.

One of the chief causes of concern in China is its vulnerability to credit problems and rising bad debts and already many of the leading banks have indicated they are likely to raise capital to further strengthen balance sheets.

The Chinese promotion of urbanisation is an established part of the latest five year plan and the central and regional government will emphasise this in their spending priorities however there is still need for reform to the existing Hokou system which restricts benefits to those moving to cities. There is also a need for land reform to help drive the expansion forward and China will need to accommodate and build for 20 million people migrating to the cities each year.

Despite concerns that China is struggling to change to this new regime the central government is clamping down on corruption and reforming restrictive legislation.

Japan

The Japanese elections in July were the most important development over the last quarter and little happened as a result. The Cabinet Office produced their first estimate of Q2 GDP at 2.6% but at the same time they revised down Q1’s figure from 4.1% to 3.6%, which is still strong relative to the recent past.

Just as Japan’s national debt reached the ¥1,000 trillion mark (approximately £6.7 trillion), including ¥830 trillion of government bonds, the Bank of Japan announced further purchase of the equivalent of $7bn of government bonds in addition to their previous stimulus programmes. Part of the government and the Bank of Japan’s policy is to stimulate inflation and there are signs that this is happening with July’s CPI figure showing a year on year increase of 0.7%.

Investors are still relatively positive on the outlook for Japan, although this has been tempered slightly - the August Bank of Japan Merrill Lynch survey showed a net 19% of investors overweight Japanese equities, which was down from 27% in July.

It is 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 having been on the currency but there is short-term evidence of an improving economy. The level of government debt continues to be a major concern, although interest rates currently remain at very low levels and there has been an increased commitment from the Bank of Japan to purchase government bonds as part of the overall stimulus strategy.

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 higher inflation starts to appear. The Japanese equity market outperformed strongly in the first half of 2013 so the recent performance is not totally unexpected and longer-term valuations are not as attractive as they were at the start of 2013 but they continue to look attractive versus historical measures. How long the overall market 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 and the Bank of Japan can lead Japan into a period of sustained economic growth.

Fixed Interest

Chart showing 2013 returns for major fixed income indices:

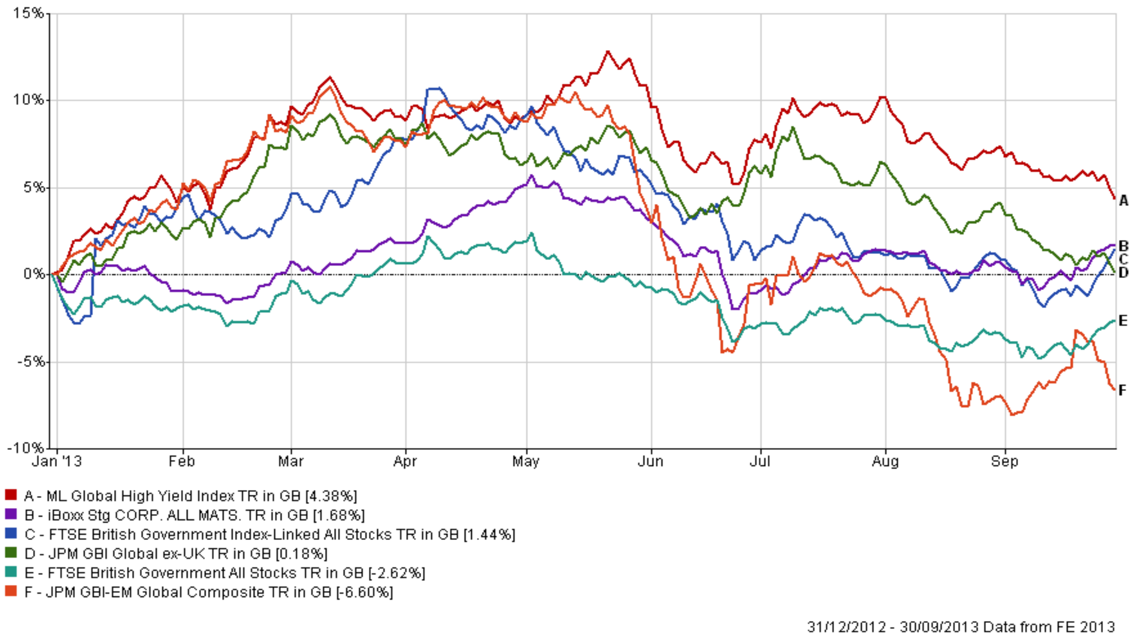
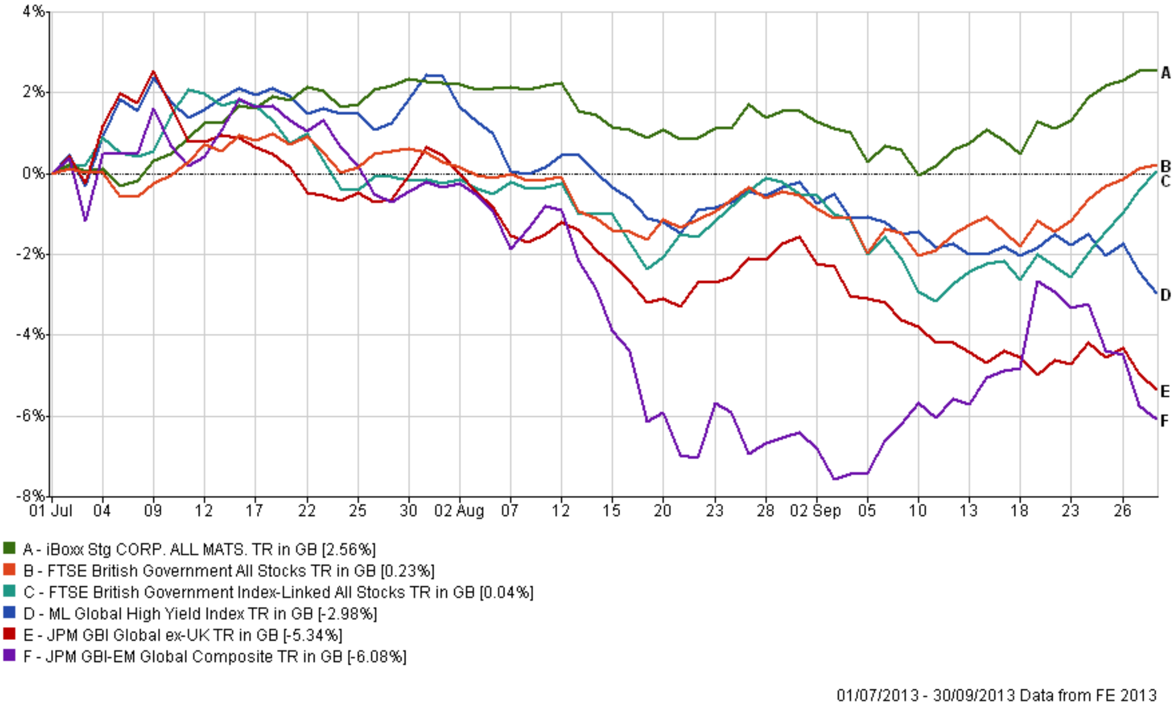


Chart showing Quarter three returns for major fixed income indices:



Little has really changed in fixed interest markets since the last outlook was written at the start of July - core government bond markets are likely to see continued upward pressure on yields as long as the economic recovery continues as expected and short term interest rates appear likely to be anchored at current levels for some time to come. Even the States is some way off actually raising rates as the economic recovery in the US remains sluggish and inflation pressures remain benign. There is unlikely to be any major tightening of policy as occurred in 1994, monetary policy has already been tightened at the long end of the yield curve as seen in the increase in US mortgage interest rates which may actually put off the necessity for the Federal Reserve to raise short term interest rates in the States. Mortgage costs are already over 100bps higher than before the Fed began talk of tapering in late May.

Returns from credit look likely to outpace those from government bonds, although even returns here are unlikely to be exciting over the medium term. Within high yield strong stock picking will remain necessary although high yield bonds continue to offer the best potential in fixed interest. The fixed interest sector does continue to offer investors some level of diversification if the global economy turns out to be worse than consensus expectations.

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 and, as a group, their credit ratings are continuing to improve. Countries that have current account surpluses and foreign exchange reserves have the ability to help stimulate their economy when necessary but countries with current account deficits are in a more vulnerable position. 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.

Global bonds look to offer some good opportunities as most western sovereign debt is unlikely to see yields fall meaningfully in the medium term and so the spreads to higher yielding areas look attractive on a risk / reward basis. The pressure on rates is more likely to be upwards provided deflationary pressures can be overcome, which suggests a more difficult environment for fixed interest in the coming twelve months.

Property

Returns from the direct property market continue to improve and the IPD UK All Property Index return of +0.9% in August followed on from a strong July and has brought the 3-month return up to a very healthy +2.5%. The office (1.1%) and industrial (1.2%) markets were the strongest performers with the retail sector lagging despite a return of +0.7%. Capital returns increased slightly from July with +0.6% growth in the office and industrial sectors and +0.1% growth from the retail sector, the first positive figure for some time.

Many of the factors regarding commercial property have not changed for a few months but, anecdotally, there seems to be increasing interest in the asset class. It should continue to be a good diversifying asset class during these difficult market and economic conditions with returns driven mainly by the yield, although signs of capital growth returning to the asset class are encouraging. Higher quality assets should continue to be a relative safe haven, although yields are falling in some areas of the direct property market (particularly London offices) due to continued strong demand for this type of asset. There remains general weakness in the high street retail sector.

There are continued rumblings that value is starting to appear in secondary markets but individual property selection will remain important within this market. Property securities will continue to be driven by both the outlook for property and for equity markets in general with investor sentiment likely to be the main factor over the short-term, however local market factors typically have a larger influence on this sector than for the main equity indices and this should be taken into consideration.

Summary

Equity markets have been trending upwards since late November 2012 and as a result the PE ratios for many companies have now moved closer to the cheap side of fair value rather than outright cheap, which they were at the start of this period. The global economy now appears to be on an uptrend, although stronger profits need to come through to justify higher market levels - most bull markets do not end until they reach over valued levels.

Investors should remember this is not a normal business cycle recovery. Exceptional measures have had to be taken to offset the effects of the de-leveraging associated with the global financial crisis and although we are now close to the point where adjustments to some of these policies will have to be made, monetary policy is likely to remain extremely accommodative by historic standards for a number of years to come. This will support valuations of risk assets and will also enable the economic recovery to gather momentum.

Managing transitions is always tricky, and markets are always unnerved by uncertainty and there are currently three transitions that need to be negotiated - the end of the QE in the States; the move in Europe from austerity to growth; and the re-balancing of the Chinese economy. This could lead to periodic bouts of volatility between now and the year-end which are likely to give investors attractive entry points to markets. Markets will remain supported by low interest rates in the developed world and potential for fiscal stimulus, albeit low key in China.

While investors are entitled to favour equities over fixed interest, especially at current valuations and the stage of the economic cycle, a diversified approach to portfolio construction remains prudent. Fixed interest funds remain the best diversifier to a downward stumble in equity markets if setbacks in the global recovery occur. Notwithstanding this, medium to longer term investors could look to increase exposure to equities on any significant setback as long as this is not driven by a downward lurch in economic activity.

Ken Rayner
Director
Rayner Spencer Mills
October 2013