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Quarterly Investment Bulletin

January 2014



General Economic Overview – Quarter Four 2013

The macro-economic back-drop generally improved during the fourth quarter of 2013 with the economic recovery continuing to gain momentum, not only in the US, but also more recently the UK and parts of Europe. China also saw a stabilisation in the growth rate together with the announcement of a reform programme, which was received positively by the market.

In the last outlook we identified the three issues that were likely to determine the performance of equity markets during the fourth quarter. The first of these was the dependence of global markets on accommodative Fed monetary policy. In other words, could markets continue to deliver gains if tapering came back onto the agenda? The second issue was Europe and how sentiment would be affected by matters such as the German election. The third issue was China and whether the economy could smoothly adjust to a slower rate of growth.

To some degree all countries and markets are united by a common dependency upon the US Federal Reserve (Fed). Volatility in markets has generally been caused by speculation over how imminent Fed tapering is likely to be. At times good news has been bad news, as stronger data increased fears of an imminent reduction of liquidity. December saw the first instalment of this liquidity withdrawal with total monthly purchase of US treasuries and mortgage-backed securities reduced by \$10bn down to \$75bn. Unlike what happened in May, this reduction in monetary stimulus was generally seen as a positive with equity markets showing small gains. The Fed's action was translated as policymakers having more conviction in the sustainability of a US economic recovery. The level of tapering will continue in 2014 but growth prospects for the US economy mean this is unlikely to derail recovery.

In the fourth quarter the euro rallied, as expansion of the ECB's balance sheet has been slower than that of the Federal Reserve. In contrast, both the yen and emerging market currencies have suffered weakness. Whilst Japanese authorities have actively encouraged weakening of their currency this has not been the case for emerging markets, which have suffered from fears of a withdrawal of liquidity. This has resulted in a focus on current account deficits and weaker economies in the region with a need to enact a reform programme to bring currency stability.

In an environment of improved economic growth, but still low interest rates, 2013 was the year for equities, as they comprehensively out-performed bonds and most other asset classes. 2013 saw some rotation from bonds to equities - whilst not the great rotation predicted by some, it is likely to continue gradually for a number of years unless there is a downward lurch to economic growth.

Despite stronger growth many commodities performed poorly, as investors factored in a slower long-term growth rate in China. It was also a year when developed markets out-performed the emerging world, as relative economic change favoured the major stock markets.

In fixed interest the thirst for yield continues to be favoured with higher yielding assets, including corporate loans, performing strongly. With growth rates likely to stay low, even though the recovery has now moved to a sustainable path, interest rates are unlikely to rise significantly over the next few years, as an end to US tapering is only pressing down less hard on the accelerator rather than hitting the brake. While some commentators had expected a pickup in inflation lots of cheap money doesn't necessarily provide demand for credit. So far the stimulative effects of QE have been mitigated by the effects of de-leveraging in the financial system.



The size and growth of government balance sheets suggests some asset prices have been distorted by Central Bank policies. Although there is now a synchronised recovery, it is questionable as to whether governments or individuals could afford rate normalisation after the damage to balance sheets done by the financial crisis. In 2014 there is likely to be a modest draining of global liquidity - the Bank of Japan has been a late arriver to balance sheet expansion and will continue to pump money into the system. There is already evidence that Japanese investment institutions are recycling some of this money abroad.

Overall 2014 has started positively with encouraging economic data but improving global growth across all regions is still some way off and will need to be reflected in company earnings through 2014 for this momentum to continue.

Equity Markets Overview

Chart showing 2013 returns for major market indices:

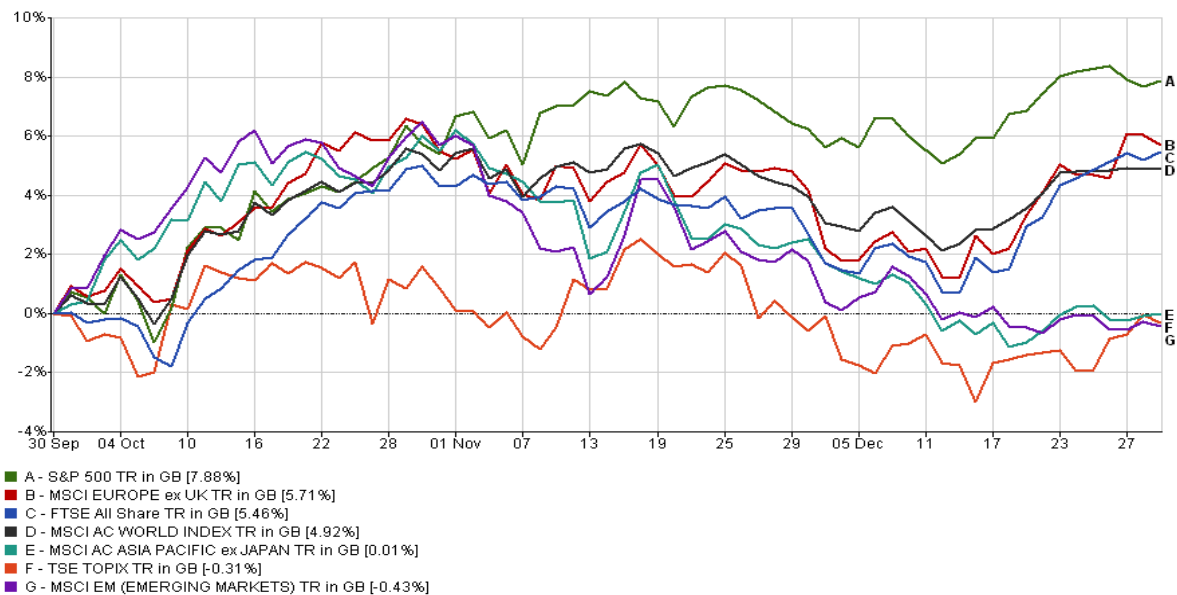


31/12/2012 - 31/12/2013 Data from FE 2014

Western developed equity markets, plus Japan, showed much stronger returns during 2013 than the more volatile equity markets of Asia and Emerging Markets, as relative economic change favoured the major economies and equity markets. 2013 also saw some rotation from bonds to equities, although not at the level predicted by some commentators. This is likely to continue for a number of years unless there is a downward lurch to economic growth and is partly the result of ultra-low interest rates, which have forced investors into both higher risk and greater illiquidity.



Chart showing Quarter Four returns for major market indices:



30/09/2013 - 31/12/2013 Data from FE 2014

Market performance during the fourth quarter of 2013 followed a similar pattern to 2013 as a whole with Western developed markets outperforming their more volatile counterparts in Asia and Emerging Markets. The US market led the way as continued improvement in economic growth, unemployment and the housing market led to investors being willing to pay a higher price for still quite subdued earnings growth – a re-rating of the market. The UK and European markets were not too far behind the US with improving economic growth figures and forecasts the main driver, albeit at very subdued levels within Europe. After performing well for most of 2013 Japan had a more subdued quarter, with returns during the quarter particularly affected by the strength/weakness of the Japanese yen versus other currencies, particularly the US dollar.

Having started the quarter well following the announcement that the US Federal Reserve chose not to reduce the amount of monetary stimulus in September, Asia and Emerging Markets continued their underperformance within a global context that occurred for much of 2013. As the fourth quarter wore on, the improving economic growth figures from the West led some investors to believe that monetary stimulus might actually be withdrawn sooner than expected, which could lead to withdrawal of previously invested capital from Asia and Emerging Markets, particular from those countries with larger current account deficits (e.g. Turkey, Brazil, South Africa).

Sector Review

UK

The UK economy has seen an improvement in growth that has surprised most commentators, with third quarter GDP growth confirmed at 0.8%, and many are now revising up their previous forecasts for 2014 and beyond. Manufacturing and Service PMI data continues to be strong and the government’s Funding for Lending (now limited to commercial lending from January 2014) and Help to Buy schemes have helped stimulate domestic demand, as a more buoyant housing sector has



brought back a feel-good factor. Whilst, in time, UK housing could enter bubble territory, at present the economy is benefitting from housing's multiplier effects. As a result UK domestic names have been some of the stock market's best performers.

The Bank of England has seen the evolution of a new approach to monetary policy under Mark Carney. The Bank has introduced forward guidance, which is a guide to the future pattern of interest rate policy and currently accounts for factors such as inflation and unemployment. However, as the economic recovery has gathered pace and unemployment has fallen quicker than expected, the market has become sceptical that rates will stay low for as long as the Bank has forecast. There remains a possibility that the Bank could further lower its unemployment guidance threshold to 6.5% or below and Carney has indicated that he has tools at his disposal other than increasing interest rates should the Bank wish to remove stimulus from certain parts of the economy.

With inflation under relative control (2.1% in November) and economic growth improving, at this stage, the UK economy seems well placed to achieve escape velocity and a self-sustaining economic recovery. Equity markets have risen strongly through 2013, well ahead of corporate earnings growth, so returns are highly likely to be lower in 2014, and the market (and individual companies) will need to demonstrate the ability to grow earnings in order for markets to continue moving forward.

Europe

The economic background in Europe has also improved and fears of a melt-down in the euro have all but disappeared, although absolute levels of economic growth remain very sluggish versus previous recovery periods with Eurozone GDP of just 0.1% in the third quarter. Germany continued to lead the way, but even its growth level fell relative to the second quarter (0.7% down to 0.3%), Spain returned to positive growth territory, albeit only just at 0.1%, France dropped into negative growth of -0.1% (Standard and Poor's downgraded their credit rating to AA), the same level of growth as Italy. This led to the European Commission slightly reducing their 2014 growth forecast to 1.1%. Growth and inflation concerns were key reasons for the European Central Bank cutting interest rates to 0.25%, which also caused the euro to fall, and for Standard and Poor's cutting the European Union's credit rating from AAA to AA+.

The German election has resulted in a grand coalition that should provide more stability within the whole of the euro block. There are also now encouraging words about a bank guarantee programme, which should remove the potential damage that a European banking crisis can inflict on its sovereign debt. Initial steps have already been taken towards this goal but there are many matters to be resolved. Banks themselves, however, are still in a deleveraging mode and the 2014 Asset Quality Review will provide a clearer picture as to the financial health of European banks and what further deleveraging, if any, needs to occur before they can re-build their lending books. Unemployment continues to be a major concern, especially in peripheral countries, although the overall Eurozone figure fell for the first time in two years in October.

European equity markets have continued to rise strongly with investors benefitting from improving economic growth but overall levels remain relatively weak. Valuation levels have become less attractive following the strong returns and companies will need to demonstrate the ability to grow their earnings in order for markets to move forward. The major macroeconomic issues have all but disappeared so fundamentals are likely to be a bigger driver of market returns during 2014. In this



environment stock and sector selection is likely to be a more important driver of returns than during 2013.

US

Economic growth continues to surprise on the upside with the latest revision of third quarter GDP growth to an annualised 4.1% representing the fastest growth since the final quarter of 2011. Given this figure, and the fall in the unemployment rate to 7% (lowest since November 2008), it was not surprising that the US Federal Reserve (the Fed) chose to begin reducing the amount of monetary stimulus with the announcement of a reduction of \$10bn down to \$75bn, taken equally from mortgage-backed securities and US Treasuries. The Fed also stated that interest rates were likely to stay close to zero even after unemployment passes below the threshold of 6½% provided inflation remains below 2½% and is expected to remain so. The new Fed Chairperson, Janet Yellen, is likely to focus on pro-growth policies, as she understands the negative impact of high unemployment on the real economy. There should therefore be an extended period of low interest rates, which should continue to be positive for US equities.

One of the contentious issues of the last couple of years has been negotiations regarding the US budget at the start of the year, so the announcement that a budget deal had already been agreed between the Republicans and Democrats was a surprise and was well received by investors. The deal was passed by the US Congress by a large majority but any new borrowing requirement still requires Congress' approval and there was no agreement regarding any increase in the US debt ceiling. This latter issue is likely to re-appear early in 2014.

The US economy continues to be helped by a rebounding housing market with its strong multiplier effects benefitting the whole economy. The US has also seen an improving current account balance and steadily falling employment rate. Over time investors could expect this to be positive for the US dollar, although this has not been the case to the surprise of many in 2013.

With the US moving to recovery earlier than most other major economies the equity market has performed very strongly and been the best performing major equity market in 2013, in sterling terms. US equities arguably look relatively unattractive compared to other equity markets, as the increase has been primarily due to a re-rating, but with the economy being on a stronger footing companies may be able to generate improved earnings growth and merger and acquisition activity should increase.

Asia and Emerging Markets

China remains the dominant economy in the Asian region and one where investor opinion is often split between optimists and those predicting a hard landing. After an early summer slowdown the bears have once again been confounded, as the Chinese economy has at least stabilised and is showing signs of recovery in many sectors with manufacturing continuing to expand, factory output rising strongly and retail sales also rising strongly. China is still a developing and urbanising nation, so the fact that fixed asset investment (FAI) remains strong at around 20% per annum, although down from peak levels of a few years ago, should not be that surprising.

The new Chinese leadership came to office around a year ago and Party General Secretary Xi, together with his Premier Li, has already stamped his mark on policy. The previous leadership had talked about reform but actually did very little, resulting in disillusionment within the population.



The new leadership has delivered on what they said they would do with many things changing in the last 12 months. Although it is early days, this leadership does seem very different from the previous administration.

The most apparent change is financial reform where the government has loosened restrictions on the private financial services industry. More banking licenses will be available and a greater offering of financial products than have been seen before. With the re-opening of the Chinese IPO market it is now easier for companies to access financing. There are other reforms including farmers' land rights and loosening of the single child policy.

After the early summer slowdown, economic indicators for the third and fourth quarters have at least stabilised and in many cases improved. China still has the ability to maintain reasonable growth rates for a period and the leadership is likely to strike a balance between reform and maintaining economic growth. Sentiment amongst investors towards China now seems to be improving from a low base.

China has slowed from its exceptional growth rate of around 10% to a range likely to be 7% to 7.5% for the next few years before later slowing to around a 6% growth rate. As a result there is a need to be aware that some stocks and sectors will be hit by this. Many sectors will suffer from a change away from an investment driven economy to one where consumption is more important.

Until Fed tapering became an issue of concern the ASEAN region had been the market darling in Asia. Investors chose to ignore that countries such as Indonesia and Thailand had deteriorating fiscal and current account deficits, often driven by unaffordable fuel or food subsidies. Indonesia has seen significant currency weakness with the Rupiah even underperforming the Yen in 2013. This has resulted in a tightening of monetary policy in Indonesia with slower growth rates in many of the ASEAN countries likely.

Emerging markets have begun to perform less as a group and have become more differentiated in terms of their characteristics and performance. In 2013 there was significant diversity between resilient economies and those with current account deficits that have been less secure. Currency has been a major driver of differentiated returns in the emerging market region. Countries such as India, Indonesia, Brazil and South Africa and to a lesser extent Turkey, have suffered from currency weakness and in many cases a tightening of monetary conditions (Brazil increased interest rates to 10%, their highest level since March 2012). Some Latin American economies are suffering from the slowdown in commodity demand from China with currencies suffering on the back of this. The Russian market continues to be dependent on the oil price with the domestic economy showing lower levels of growth.

The best opportunities in the emerging world are likely to lie within countries undergoing restructuring and reform. In this environment emerging market fund managers and investors may need to be more discerning in their stock, sector and country allocations and blanket exposure to an index is unlikely to be an optimum strategy.

Japan

In Japan the final verdict on Abenomics has yet to be determined, as Prime Minister Abe's 'Third Arrow' has yet to be fired but investors have certainly been optimistic so far with the Japanese Nikkei index producing its largest annual gain since 1972. Economic growth has shown signs of



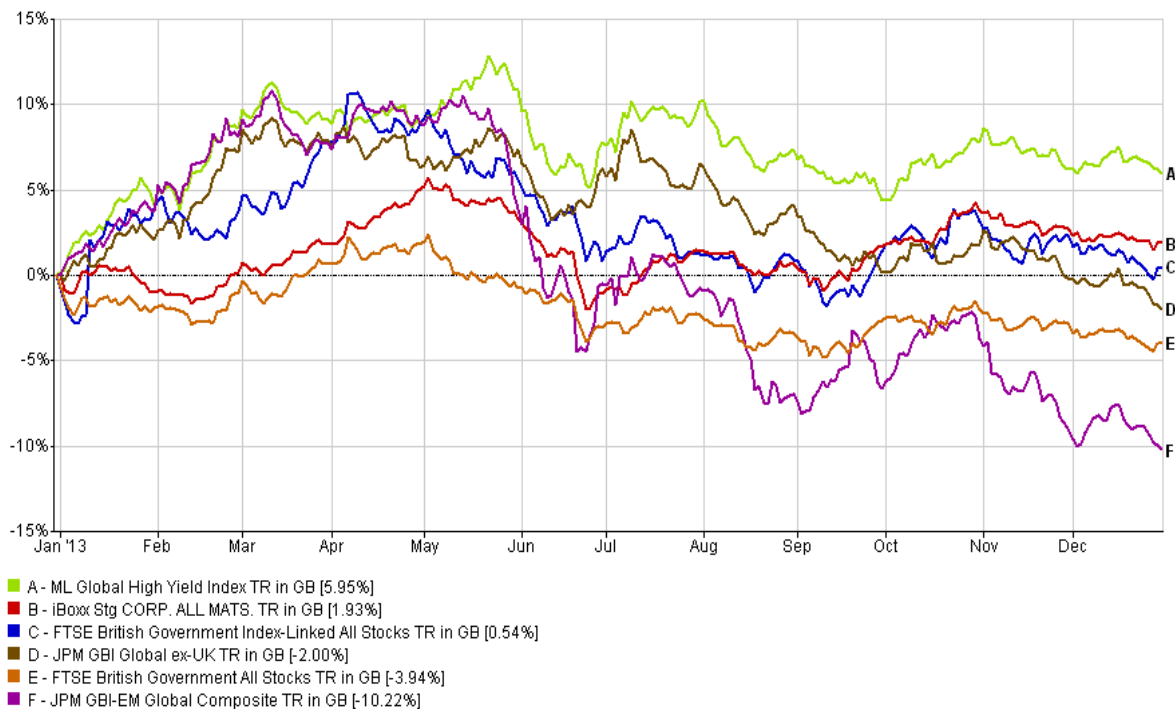
weakening with third quarter GDP growth of 1.1% annualised below expectations. Corporate spending was weak but consumer spending was strong, possibly due to the impending consumption tax rise. Should growth remain relatively weak then the government may feel compelled to act with further fiscal and monetary policies.

There has been a pick-up in inflation but part of this has been driven by currency weakness, rather than increased levels of domestic demand. Japan needs wage growth to come through in an economy where salaries have been stagnant or declining for a decade and there are tentative signs that this is beginning to happen. Although there have been a few companies where wage rates have increased, it is still too early to say whether this will be a trend over coming months.

The outlook for the Japanese market is one where bulls and bears remain split. If Abenomics really works and inflation moves to the 2% level there is scope for further significant gains in the Japanese market. However, if both the economic recovery and reform process in Japan peter out, with deflation returning and no wage growth, markets may give up some of the gains of the last 12 months. A couple of lesser-known factors that may support equity markets are the creation of a Japanese savings account (NISA) and the Japanese Government Pension Investment Fund increasing its exposure to equities and other riskier assets.

Fixed Interest

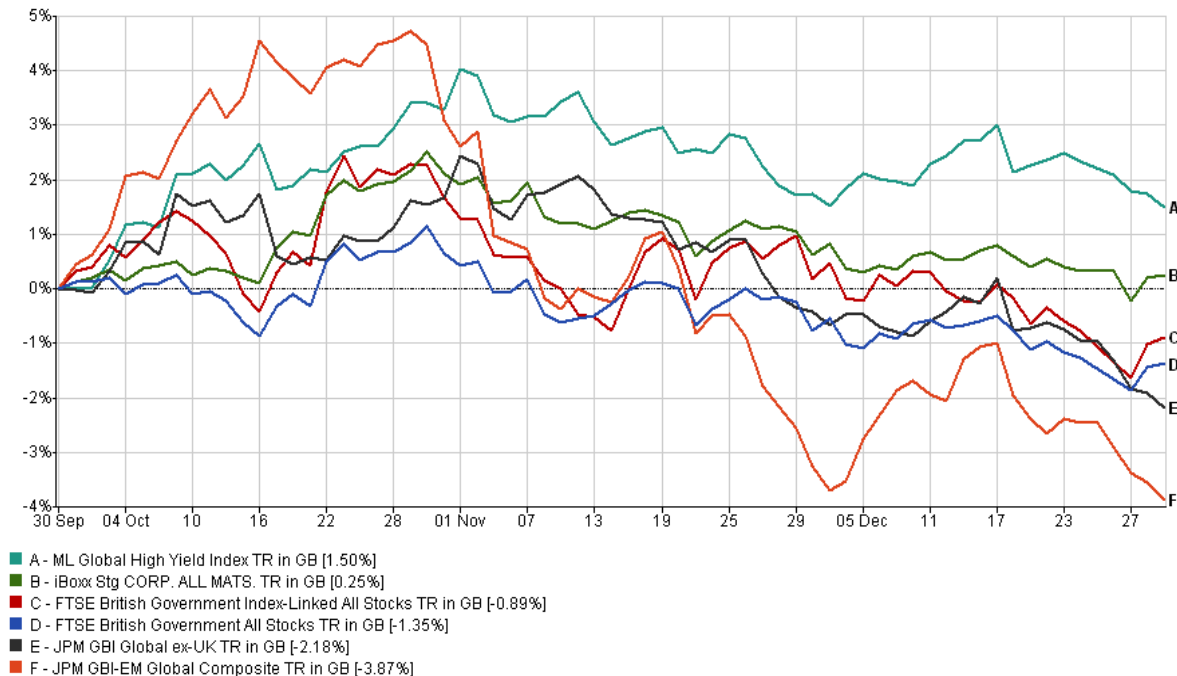
Chart showing 2013 returns for major fixed income indices:



31/12/2012 - 31/12/2013 Data from FE 2014



Chart showing Quarter Four returns for major fixed income indices:



30/09/2013 - 31/12/2013 Data from FE 2014

The outlook for government bonds is little changed from that of three months ago. Financial markets and economies are clearly in better shape than 12 months earlier, which is reflected by not only higher equity prices but also significant declines in southern European sovereign bond yields. Despite this positive outcome economic data has not been that strong in some regions, namely Europe, Japan and Emerging Markets, certainly by historic recovery periods. For many economies the challenges of high levels of public and private debt have not gone away. Economic growth does allow time for these to work out of the system and the environment remains one where inflation is expected to be muted and, as a result, central banks are likely to keep interest rates ultra-low, maintaining their general pro-growth stance. So, despite general investor unease with the levels of government bond yields, a significant backup in yields, even over the next 12 months seems unlikely, as long as inflation remains benign, and we are likely to be many years away from interest rate normalisation. This is partly because the short end of the yield curve will remain anchored, as these bonds are priced off short term interest rates.

For the last couple of years credit has outperformed government debt. In the case of high yield this has been significant, as high yield corporate bonds are much more of a proxy for equities than sovereign debt. The fundamental outlook for corporate bonds remains positive, as this is still a relatively slow growth environment and corporate balance sheets remain in good shape. Credit spreads are now tighter than at the start of the year and close to historic averages, so the same level of excess returns from the asset class seem unlikely, but we may see further spread tightening, although some of the returns are likely to be whittled away by a modest rise in government bond yields. Credit will, in all likelihood, struggle to deliver much more than the coupon and in high yield after its strong run strong stock selection will be vital. Investors in this asset class need to keep a close eye on security of covenant, as some higher risk issues have entered the market due to the thirst for yield. Credit is a market where strong stock selection seems essential for investors to receive a decent return.



The main argument in favour of core government bond markets is the diversification they offer compared to equities. Investors should remember however that if equities go up and bonds go down diversification has in fact been achieved. Investors hoping to have both a positive return and diversification benefits from fixed interest need to choose managers carefully. Funds with strong records in macro asset allocation are likely to continue to perform best in this challenging fixed interest environment.

Property

Returns from the direct property market have continued to improve and the IPD UK All Property Index return of +1.5% in November followed on from a strong October and has brought the 3-month return up to a very strong +3.8%. The office (1.9%) and industrial (2.2%) markets were again the strongest performers with the retail sector lagging despite a return of +1.0%. Capital growth has been returning to the sector and outpaced income returns in November (0.9% versus 0.5%) with the office and industrial sectors again the strongest.

Commercial property continues to attract both institutional and retail investors. Interest from overseas investors has been a key driver of the asset class during 2013 with Central London the main focus of their attention but there is anecdotal evidence that investors are increasingly looking outside Central London and towards regional markets, given the generally improving economic environment, and that domestic investors are becoming increasingly prevalent – the third quarter was the first time since Q1 2011 that overseas investors were not the largest net investors. The third quarter also saw the capital value of properties outside London increase by 0.8%, leading to a total return of 2.4%, which was the highest level in three years. This continued on from the second quarter where capital growth was positive for the first time since 2011.

Property continues to be a good diversifying asset class during these difficult market and economic conditions with returns driven mainly by the yield, which remains attractive given the relatively low yields on 'safer' fixed income assets. Higher quality assets should continue to be a relative safe haven, although yields are continuing to fall in some areas of the direct property market (particularly London offices) due to continued strong demand for this type of asset but returns from regional areas are showing the greatest improvement.

Individual property selection will remain important within the direct market whereas 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. 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

After strong gains in equities in 2013 many investors are worried about potential 'bubbles'. Although valuations have risen, markets are still some way from being in bubble territory, as even US markets are not trading above historic averages. The global financial crisis and its aftermath mean this economic recovery will not be typical and this has already been demonstrated by muted growth rates in the early recovery period.



For the world to shake off low growth there is a need for banking systems to be fixed and the credit multiplier to start working again. In the last couple of years the chief driver of markets has been an expansion of the Price/Earnings (PE) ratio. This is typical of recovery after a recession, as many investors are slow to believe that the economic background is actually improving. Further returns will need to be driven, at least in part, by earnings growth, as without this markets could re-rate further into expensive territory. The PE on global markets is now around fair value rather than cheap, however cyclical forces favour equities due to the stage of the economic cycle, especially when interest rates will remain highly accommodative for a period of time.

With significant spare capacity and excess labour still in the global economy inflationary pressures will remain muted for some years to come. Central Banks have recognised this and taken a pro-growth stance with significant changes in personnel in both the ECB and the Bank of Japan. As a result, monetary policy will remain accommodative for some years to come. Thus although equities are no longer cheap, cyclical factors are likely to support further gains in markets in 2014.

Investors should be mindful that there are always risks in markets and these typically increase as markets re-rate upwards. As a result some level of diversification in portfolios remains prudent. Fixed interest remains the asset class most distorted by QE, so conventional or core fixed interest funds look likely to struggle in an environment where interest rates will eventually rise. As a result investors would be best to concentrate on 'strategic' funds where strong macro management allows the potential for gains ahead of inflation, although more muted than previous years. Some element of absolute return funds within a portfolio would also be a prudent choice, though once again fund manager selection in this field is critical. Investors can expect further market gains but should remember there has already been a strong run in equities and Fed tapering occurring faster than expected or an unexpected exogenous shock could always cause periods of volatility.

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