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Quarterly Investment Bulletin

April 2014

General Economic Overview – Quarter One 2014

Since our January review, momentum of world equity markets has certainly slowed with January and February cancelling out each other in terms of market movements, and March seeing little change.

At the start of the year, we felt we would need to see earnings growth at a company level before markets could move forward, but so far the evidence for this has been patchy. This uncertainty for investors has been exacerbated by other events around the globe, some of which were already on our worry list – including declining financial stimulus, as QE reduced, and a broadening of the slowdown in China –but others were unexpected events such as those in Crimea and the Philippines.

There is some evidence that investors have become more defensive since the start of the year as bond yields have remained lower than expected and gold has seen some strength returning. This is to be expected as financial markets have been on a long bull run and many risk assets are now showing signs of being fully valued, particularly in developed markets.

It is worth putting the situation into a longer term context to be able to understand what is currently happening and what we expect to happen for the rest of 2014.

The 2008/09 recession caused by the GFC was not a typical business cycle downturn. It was a balance sheet recession, caused by too much borrowing. It occurred at a time when equities were less obviously over-valued than many other asset classes and this over-valuation of other asset classes ended up impacting negatively on equity markets and deepening the economic downturn. As a result of this unconventional economic downturn, developed economies have adopted highly unconventional monetary measures to offset the rolling de-leveraging that followed. The global economy has had to withstand de-leveraging first in the corporate and personal sectors and now more recently in the government sector.

It is now over five years since the US Federal Reserve (FED) adopted its zero interest rate policy and subsequent quantitative easing (QE). These measures have been followed, at different times and with different degrees and emphasis, by central banks in the UK, Europe and Japan. This unprecedented monetary expansion has coincided with a strong recovery in equity markets - the US stock market is now up over 170% from its lows in 2009.

The central banks hope to unwind policy measures slowly, however this may be a more difficult exercise to manage smoothly than market participants believe and in this environment investors too would be well advised to proceed with some caution. Whilst further equity gains are in prospect, the strong valuation support of previous years is no longer present - the US remains the world's dominant equity market and here shares are on the wrong side of fair value. There have also been some signs of excessive risk taking in investor behaviour, as demonstrated by some frothy recent IPO valuations such as AO World and King Digital Entertainment (the company behind Candy Crush Saga). As a result the path to higher share prices is likely to be more challenging in 2014 than was the case in either 2013 or 2012.

In summary, whilst we do not see the global recovery being undermined in 2014 we do feel that any gains made will be hard won and based more on fundamentals than speculation.

Equity Markets Overview

Chart showing 2013 returns for major market indices:

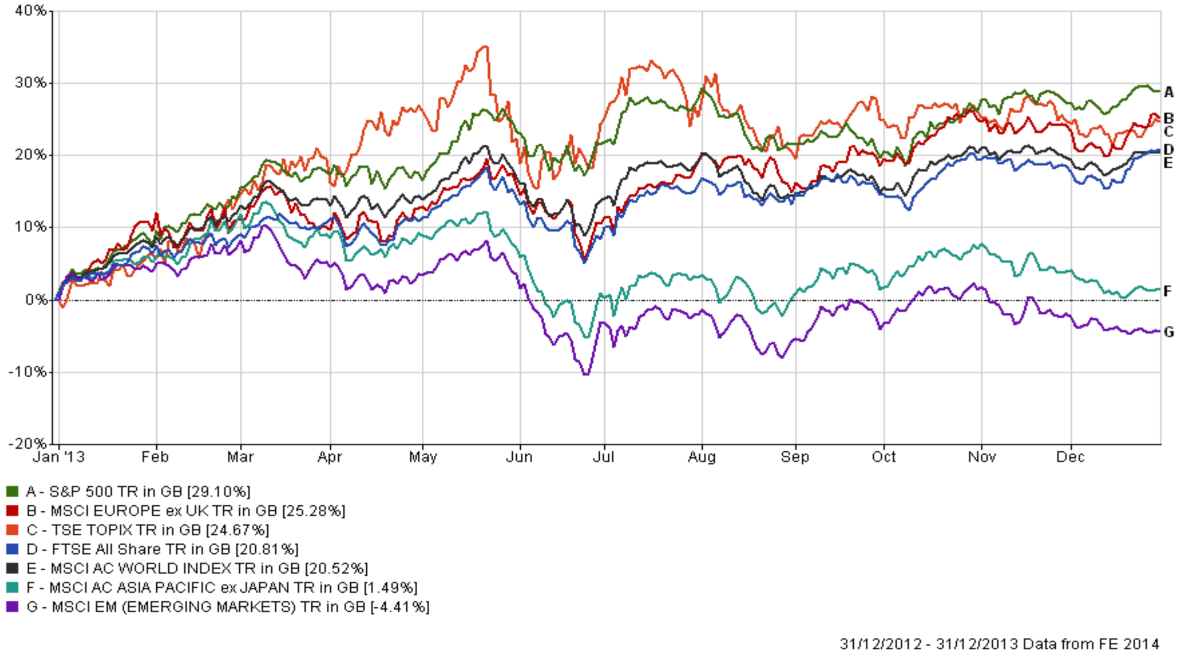
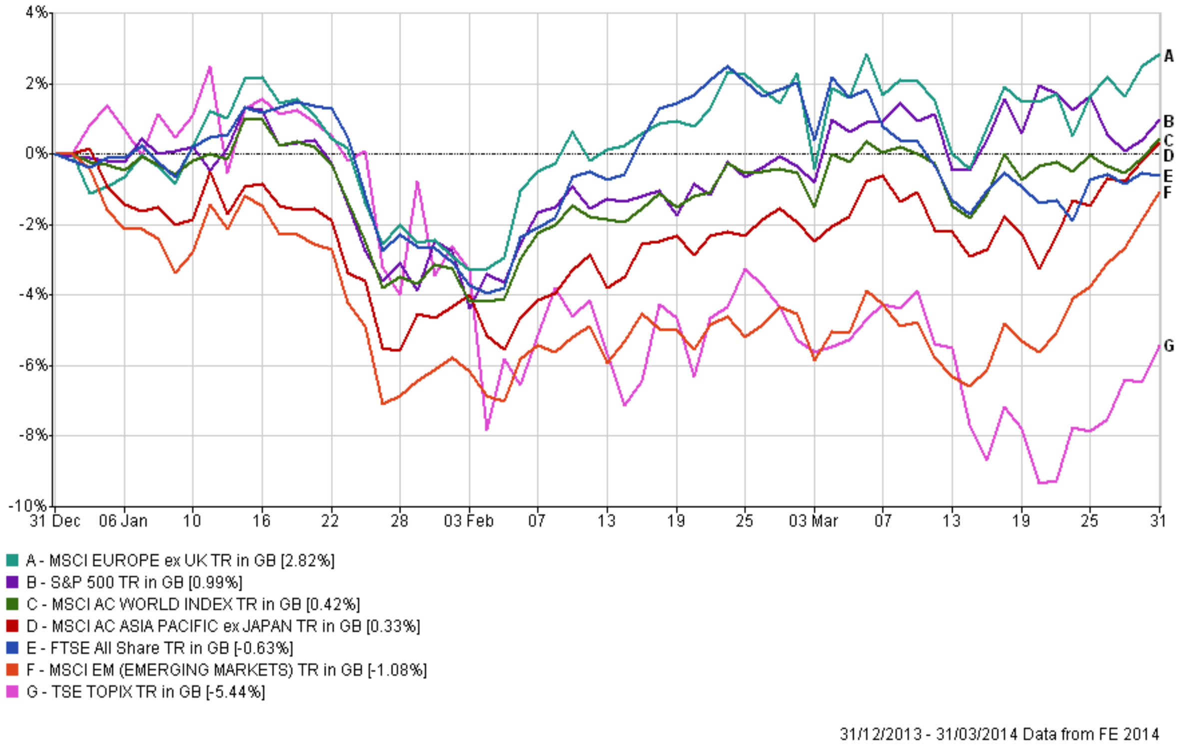


Chart showing Quarter One returns for major market indices:



Equity markets have moved little in the first quarter with Europe having the best quarter and Japan having the worst quarter unlike in 2013 when the latter made significant gains. The political and economic uncertainty has been difficult for investors and the softening of data in the US plus the continuing slowdown in China has reinforced the uncertainty created by political events in the Ukraine and in other areas of the world. Volatility has increased and sentiment has adjusted to these conditions, although we don't think that this combination of events is an inflection point for markets.

Japan is an interesting but separate case. Whilst still affected by global events it has been supported by Abenomics and has ridden a tide of optimism that has driven up markets. This has waned in recent months as the results on the economy have been less obvious and inflation has not moved up enough to reassure investors. Foreign investors make up much of the market and they have retreated causing falls.

Valuations in other markets such as the UK and Europe appear under rather than over-valued and after last year's sell off many emerging markets look cheap on historical valuation measures. Looking at historic returns over 10 year periods from current PE levels suggest while the UK market could deliver 7% p.a. compound, the US is likely to be nearer the 4-5% p.a. mark.

Sector Review

UK

The UK is one of the strongest of the developed markets and has seen some good recovery in the last two quarters. Estimates of GDP growth in 2014 are heading to 2% and the global market is waiting to see if we will be the first western developed market to raise interest rates. This is all positive for equity markets, although the austerity programme remains and the government have not yet achieved the levels of deficit reduction that they had anticipated.

The UK has also seen a significant improvement in the domestic economy with the housing market once again the driver. Manufacturing has a more buoyant outlook and for the first time in many years, wages are rising faster than prices which means the recovery should be self-sustaining.

In the UK market the main gains in 2013 were in mid and small cap stocks and in cyclical areas of the market such as financials, cyclical industrials and consumer discretionary. This has eased off in 2014 but may well remain a theme if investors can shake off the weaker first quarter uncertainties and earnings start to come through.

Europe

Europe feels much more stable than it did six months ago, and markets have tended to reflect this with economic activity stabilising in 2013, and a modest uplift in GDP towards the 1% level is in prospect this year. Economic conditions in the periphery show some signs of improvement and with fiscal and current account positions improving, an easing in austerity programmes has occurred. As demand remains sluggish and inflation well below its 2% target, the ECB has the scope to ease monetary policy further if required, quite likely by unconventional measures. Under the supervision of the ECB, European banks will have to reveal results of stress tests by September, which, assuming these are done on a realistic basis, are likely to show widespread capital deficiencies which could renew concerns over the health of the financial sector and there is a reputational issue here for the

ECB who will not want to be seen presiding over a whitewash. Some estimates suggest an amount as high as €50 - €90bn may be necessary for recapitalisation and closing banks. The Single Resolution Mechanism (SRM) was intended to provide immediate funds for this situation but, as has been typical for the European crisis, the amounts available initially are likely difficult to access and quite small. There has at least been some softening in Germany on this issue which should help to ease the process overall.

In Europe the sense of crisis has dissipated, but the basic flaw in the design of the euro remains. Europe still has a monetary union without a fiscal union – an issue which needs some form of long-term resolution, to date markets have accepted the 'pretend and extend' strategy for dealing with the debt crisis. As the fiscal positions of peripheral economies have improved, markets have been able to continue in the hope that credit worthiness is essentially intact, with extensions on the terms of borrowing typically at lower interest rates. Improvements to the budgetary position in peripheral countries and some progress on structural reforms has meant that investors have been willing to accept this approach to the resolution of the crisis.

There remain some weak points across Europe but the problems have become less of an issue on the global stage, allowing sentiment led investing to ease and market correlations to fall. The longer term prognosis for Europe still remains difficult particularly in relation to the currency and to a stronger fiscal union which many feel needs to happen to protect against the problems that occurred following the financial crisis.

US

2014 should be a year when US GDP improves further from its 2% rate to at least a 3% growth rate and the impact of fiscal drag will moderate. Weakness in the economy in the first quarter is likely to have been weather related and consumer confidence and spending is rising as households finish de-leveraging and there are tentative signs that business investment is finally starting to improve.

Credit conditions in the economy continue to improve with US banks able and willing to lend and after the recovery in the housing market, not only does the multiplier effect from this continue to be a positive for many sectors of the economy, but households are starting to enjoy positive wealth effects from higher house prices. Despite the recovery, inflation is likely to be contained below the FED's 2% level, given the economy is operating below capacity. FED chairperson Janet Yellen has indicated she is very concerned about the real effects of unemployment on ordinary Americans and so may possibly take some chances with inflation before raising interest rates by significant amounts.

The size the US means it is the dominant influence on equity markets globally and so the US valuation matters. Using PE ratios the US looks modestly expensive on an historic multiple of around 17.5x, but is some way short of the extended levels normally associated with equity market bubble conditions. Of course equity valuation is not a precise science, and there are many opinions on what are the key determinates of a fair value PE. A US PE in the 15–20 range is not untypical of low inflation environments. Relative to bond yields, equity earnings yields (the reciprocal of the PE) remain attractive at around 5.7% although this may well reflect to some degree the over-valuation of the former asset class.

Monetary policy and base scenario economic outcomes remain supportive of higher equity markets however there are a number of potential challenges to the bull market in 2014. The first of these could ironically be that US growth accelerates at a much quicker pace than anticipated, raising inflationary concerns and prompting investors to reject the Fed's timetable for no short-term interest rises until 2015, and increasing the fear of aggressive monetary tightening at a later date. The Fed will want to ensure the transition to private sector led growth takes hold firmly – Janet Yellan has always been viewed as an inflation dove and may be prepared to trade off medium term inflationary risk for nearer term faster growth.

The challenge to equities could be if bond markets take fright and bond vigilantes force long-term interest rates appreciably higher. Ten year treasuries, which currently yield around 2.7% are still supportive of current equity market valuations but a rapid back up in yields to the 4 or 4.5% level would likely cause some angst to equity markets which would not be able to ignore a bond market collapse, this however is not the our 'base case' as it suggests a lack of central bank intervention.

Asia and Emerging Markets

The broad Asian region has continued to suffer in market terms because of the more specific threats created by the reduction of QE in the US. This should be focused more on those highly indebted countries such as India and Indonesia but has had a wider effect. The region is also dominated by China and concerns over Chinese growth which has been a continual theme for markets since mid-2013.

In China, GDP is expected to slow from the 7.5% of 2013 and there is currently some concern regarding the extent of this slowdown, although Chinese consumers still enjoy growth in disposable incomes as seen by the 17% annual increase in mainland visitors to Hong Kong. Whilst attention has been paid to poor export numbers, it is likely that these numbers were inflated to some degree a year ago, making comparisons from 12 months ago tough. There is also concern about the levels of debt in the shadow banking system. A corporate bond in China was recently allowed to fail - an indication of the authorities allowing market forces to prevail, something that is necessary for the reform program to succeed.

In 2014 growth could well come in below the official 7.5% target to a still healthy 7% rate and over the next few years the growth rate may slip further to 6%, as the government seeks to wind back excessive lending and move the economy on to a more balanced structure with consumption having a larger role. This is unlikely to be of concern to the authorities as long as China has full employment - the country's changing demographics means a lower level of growth now supports full employment compared to ten years ago. Inflation is anticipated to remain around the 3–3.5% level, but currently remains below this, low food inflation is a positive for the Chinese economy and the Party will be comfortable with lower headline GDP numbers as long as living standards in China continue to rise. A slowdown in the housing market is also unlikely to worry the authorities, as housing unaffordability always has the potential to trigger social unrest. The Chinese leadership will continue to manage the economy in a way which does not allow any potential threat to the Party's rule which was one of the drivers of the anti-corruption drive under Party Secretary Xi which will continue. Understanding Party policy remains paramount for any investor in China.

In customary Chinese fashion, the new leadership is taking a gradualist approach to its reform programme, reforms which include financial liberalisation, rural land reform, hukou reform and an increasing role for the private sector. The target of the leadership is to gradually shift the engine of growth away from investment into consumption and the Party will ensure that this shift does not result in significant increases in unemployment which could always be a trigger for social unrest.

Levels of unemployment are much more important to the Chinese authorities than the headline growth rate which means little to ordinary workers.

In India optimism that a reformist government will be elected under BJP candidate Modi has led to a rally in both the stock market and currency. Elsewhere, Indonesia has benefitted from an improvement in the current account and the prospect of the election of reformist candidate Jokowi as President in July, which has resulted in a significant uplift to the stock market. Last year these two markets were some of the weakest in the emerging world, but this year the opposite has been the case - both India and Indonesia entered 2014 as unloved markets demonstrating contrarian calls can be right. The entire emerging market universe is trading at historically low valuations versus developed markets and whilst issues of structural reform remain necessary, these markets have strong valuation support after the de-rating of recent years.

Japan

In Japan, Abenomics lifted the economy in 2013, but the pace of growth is likely to slow towards 1% in the next fiscal year, in large part due to the 3% rise in the expenditure tax. This will have a one-off impact on inflation which is set to rise, but will fall short of the 2% target in 2014. To reach the targeted 2% inflation level further yen depreciation is necessary, but whether this is acceptable to Japan’s other Asian neighbours remains a moot point.

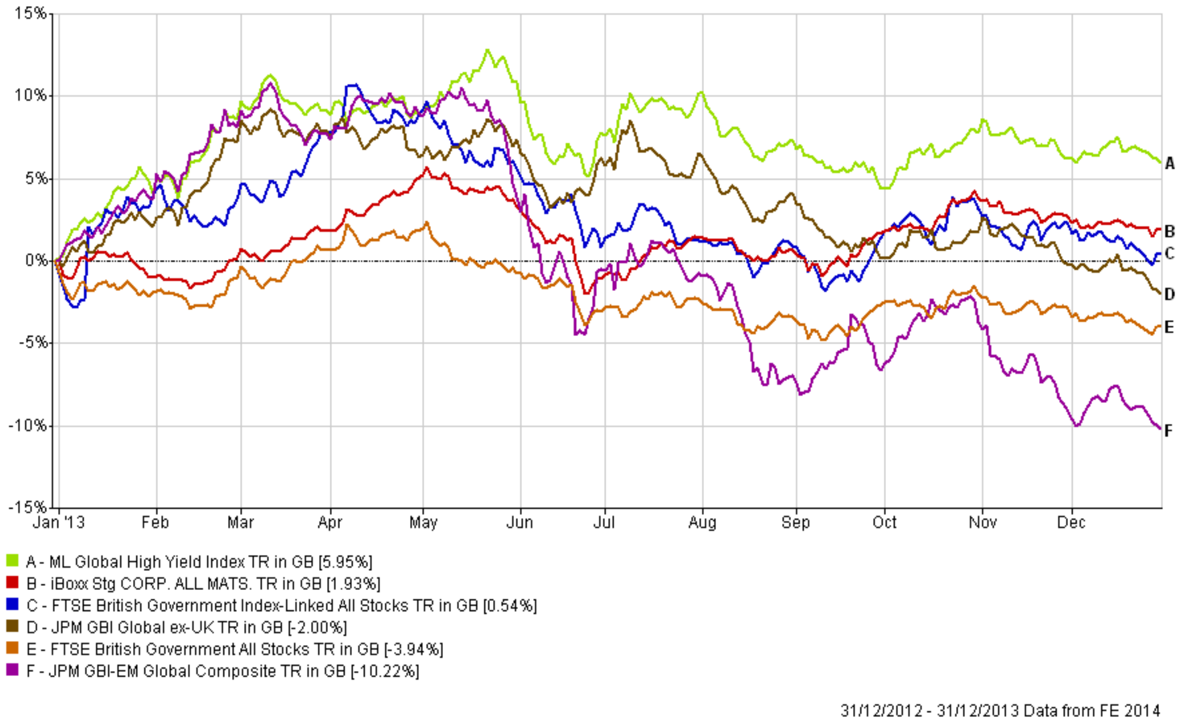
Japanese workers need to see higher wages to benefit from a rise in inflation. So far service sector inflation, which is domestically generated is sluggish, whilst sectors exposed to imports have seen prices rise as the Yen weakens. Wages need to keep up with inflation for Abenomics to work and here the jury is still out. If this does occur the Japanese stockmarket has significant upside potential with company profits forecast to grow 30% in fiscal year 2014. Japan is no longer an expensive market with the prospective PE for March 2015 having fallen to around 12x, however investors should be cognisant that Abenomics remains a high risk experiment with no guarantee of success.

In Japan investors were hoping for at a rise in the inflation rate to 2%, ignoring the fact that ten year government bond yields of around 0.6% are unsustainable if this occurs. Any sharp upwards move in long-term interest rates is likely to create budgetary problems for an economy with debt to GDP ratio of 240%. If bond yields rose to 2% interest payments would account for around 25% of current tax revenue. The Abe government is gambling that tax revenues will rise substantially if the economy in Japan recovers.

The Japanese market was the worst performing market in the first quarter due to the worries about the effectiveness of the Abe plan and the general fears over the Asian region.

Fixed Interest

Chart showing 2013 returns for major fixed income indices:



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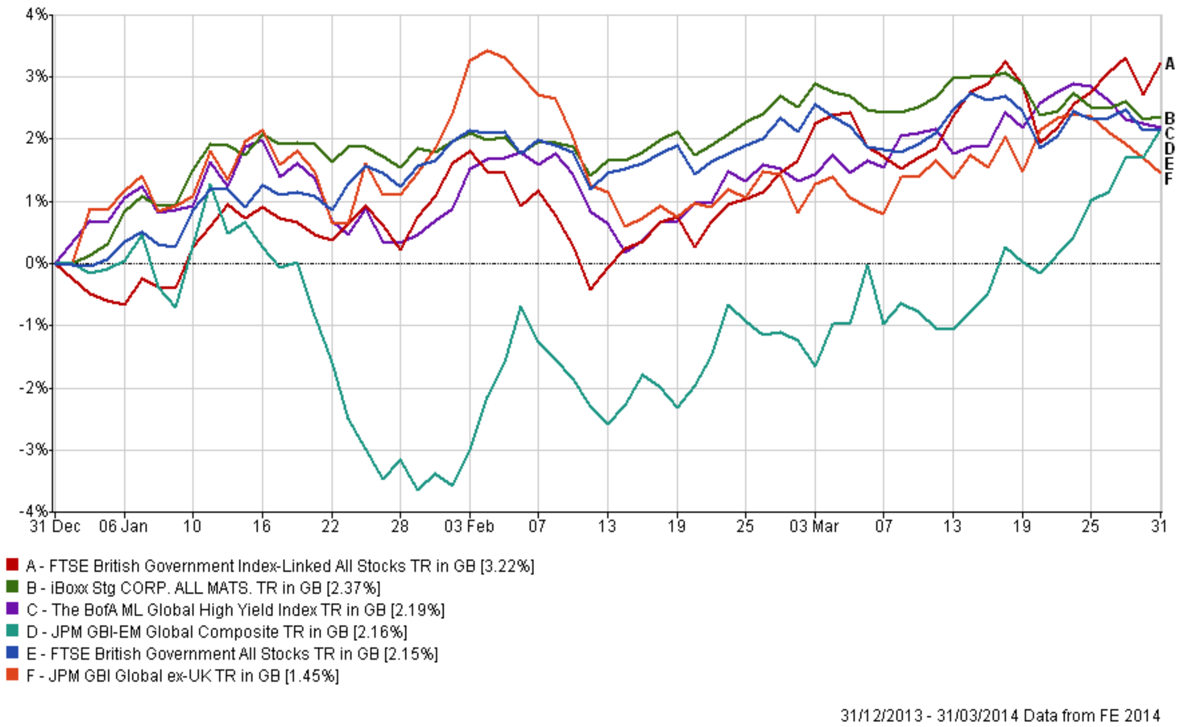

The reduction in QE by the US has resulted in further speculation about when and if interest rates will be raised in western economies. Statements by the Fed have been micro analysed and resulted in some observers suggesting that the likely increase will arrive faster than anticipated. More recent statements by the Fed have however distanced themselves from this view indicating the continued fragility of the recovery.

Ultimately, the perspective of most managers is that this rise in interest rates will occur in the next 18 months in western markets with the most likely economies to raise rates being the UK and the US. This is, of course, a consensus longer term view, and in the last quarter we saw uncertainty come back into markets and yields creep down again, particularly during February. A number of investors sought to take advantage of this at the long end of the yield curve with some increasing duration to balance portfolios against these short term movements.

In credit both investment grade and high yield bonds made gains in the quarter but many feel the spreads between assets have tightened to a point where further gains in 2014 will be more difficult to attain. Issuance has also been restricted giving manager's difficulty in getting exposure to the full value of the assets required - banks in particular, because of de-leveraging, have created less issuance and corporates have concentrated on re-financing. There are some signs however that this is beginning to improve particularly in the high yield areas.

The risks remain that the western economies, notably the US, will begin to reach escape velocity in growth terms and lead to a rise in government bond yields. The outlook then will be more negative for bond holders and holding shorter duration or lower grade assets may be the only way to eke out some relative performance. The sweet spot may then be areas such as peripheral Europe where uncertainty may provide opportunities as weaker balance sheets constrain the companies from being too shareholder friendly, continuing to appease bond holders.

Property

The recent strong returns from the property market are possibly a result of investors looking for an alternative to their fixed income allocation. It should continue to be a good diversifying asset class during these uncertain market and economic conditions with returns driven mainly by yield, although capital growth returns are now much stronger. There are some concerns that the highest quality assets are looking overvalued, particularly in London, but they are likely to continue being a relatively safe haven due to continued strong demand for this type of asset.

There are an increasing number of views that value is starting to appear in secondary markets but individual property selection will remain important in 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. That said, 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

Forecasting in the current environment is more difficult than might be expected, as after the unprecedented central bank policies there is no firm history to judge markets against. In this environment it would not be advisable for investors to go out on a limb in any asset class. After the strong gains, by mid-January the markets had got a little on the hot side with multiples, particularly in the US, on the wrong side of fair value. Equity markets have since suffered a small setback, whilst credit markets have, to the surprise of many, recorded gains in the first quarter.

2014 is likely to be a year when markets offer investors less of a one-way upward bet with periods of consolidation and weakness likely from time to time. Company earnings need to improve however this seems more likely in the current economic environment and so this may be a year where markets need to wait for a while for earnings to catch up to current valuation levels. Notwithstanding this, Central Bank policy is likely to remain broadly favourable for equities.

Longer term investors should still remain in the markets, although this would not be the time to look to significantly increase weightings to developed market equities without some sort of market correction. Many investors would be surprised to read that equities are now riskier than they were two years' ago because markets no longer have the valuation support that was present during 2012 and much of 2013.

As always, there is of course the opportunity for unforeseen events to occur or current events to escalate, in which case more volatility will ensue.

Ken Rayner
Director
Rayner Spencer Mills
April 2014