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Quarterly Investment Bulletin

July 2014

General Economic Overview

As we move into the second half of 2014 we have an improving global picture as data supports continued economic growth, although markets have become more cautious this year. Attention has recently been focused on the potential for interest rate rises and therefore of inflation although in some economies, such as Europe, deflation is still seen as a possibility. There has also been the disruption created by political change in more volatile environments such as Iraq and the Ukraine. These events, whilst limited in terms of influence on world GDP numbers, are magnified by the uncertainty they create and the potential for contagion into other areas. This has left stock markets sitting at much the same levels as when we entered the year after a very strong 2013.

The world economy is growing at a positive rate with western countries leading the way, however there is an underlying set of issues that many feel are unresolved – the effect of US tapering for example has yet to be fully evaluated against a backdrop of reducing liquidity. Bond markets have been supported by central banks for some time which has resulted in lower than expected yields when compared to where they should be in a traditional economic cycle. Wage growth across the world has been muted and is only now creeping ahead of inflation but only because the latter is falling not generally because wages are pushing ahead. Western Central banks need inflation to erode their huge debt burdens so do not want to see inflation fall too far.

Although more people are in employment, the type of employment is increasingly part time and through self-employment. This is a potential structural change that is more short term in nature and weakens the overall picture. This is also being exacerbated by the debate on wealth inequality – surveys suggest the recent crisis has made this inequality worse, and in particular it is the middle class in western markets that are the most squeezed. There is however contradictory research that suggests little has changed in inequality, except for at the very top and bottom end, but uncertainty surrounds the interpretation of the data. These issues could be significant when estimating the likely path of the global economy over the next 6-12 months.

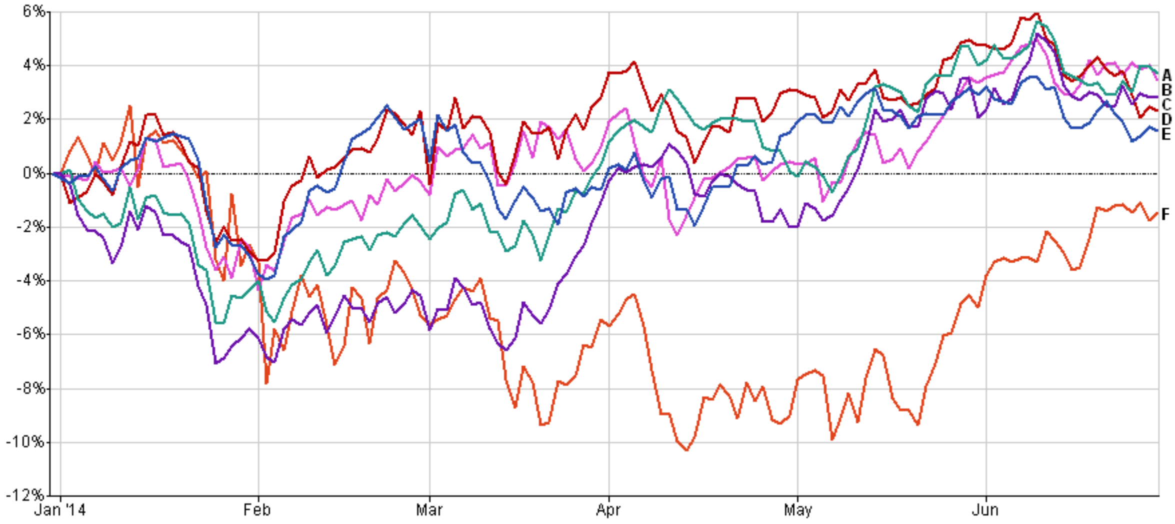
Many of the policy setters in the central institutions have moved positions in recent times, getting away from the reliance on forward guidance to a more flexible approach. We have already reached some benchmarks that were indicated as inflection points for interest rate rises with no change taking place. The consensus has been that rates will stay lower for longer but this has been challenged more recently as central bankers, such as Mark Carney at the Bank of England, have indicated that we should be prepared for action sooner. Of course this will be country dependent as we have seen rates rise in Australia recently and fall further in Europe indicating very different problems face different economic groupings.

Elsewhere investors have become increasingly worried about Chinese growth and the effect this is having on Asia in general. Those placed in the region are more positive, believing that the current leadership are relaxed about growth falling back as the economy moves into a more domestic led phase. Banking is one area of concern particularly in the regions where less is known about the extent of the debt in the shadow system that exists.

Overall we remain positive for the continuation of economic growth but believe that support is needed from the consumer who is yet to show signs of breaking out of a self-imposed austerity driven by the previous crisis. In world stock-markets there is a need for validation of current market prices with earnings announcements being watched carefully for signs of real top line growth and not just from cost cutting and mergers and acquisitions.

Equity Markets Overview

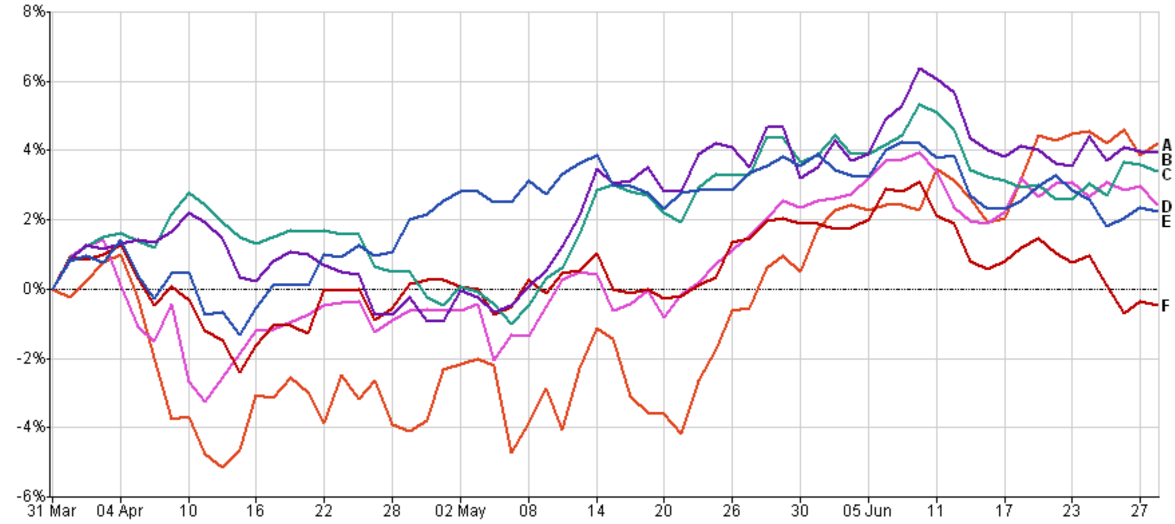
Chart showing 2014 returns for major market indices:



- A - MSCI AC ASIA PACIFIC ex JAPAN TR in GB [3.73%]
- B - S&P 500 TR in GB [3.46%]
- C - MSCI EM (EMERGING MARKETS) TR in GB [2.81%]
- D - MSCI EUROPE ex UK TR in GB [2.32%]
- E - FTSE All Share TR in GB [1.59%]
- F - TSE TOPIX TR in GB [-1.45%]

31/12/2013 - 30/06/2014 Data from FE 2014

Chart showing quarter two returns for major market indices:



- A - TSE TOPIX TR in GB [4.22%]
- B - MSCI EM (EMERGING MARKETS) TR in GB [3.93%]
- C - MSCI AC ASIA PACIFIC ex JAPAN TR in GB [3.39%]
- D - S&P 500 TR in GB [2.45%]
- E - FTSE All Share TR in GB [2.24%]
- F - MSCI EUROPE ex UK TR in GB [-0.49%]

31/03/2014 - 30/06/2014 Data from FE 2014

The return from markets so far this year has been much more muted than in 2013 as we have seen a reversal in momentum since the first months of the year. This is due to a number of issues that have combined together rather than one specific cause, including the long term effect of US tapering. This, combined with a poor start to the year for company earnings and lower than expected GDP growth in the US (due to the weather related effect), meant investors and markets started to adopt more defensive approaches. This does not mean they have abandoned equities, rather that they have shifted stance to hold more defensive assets within the equity markets. This year large and mega cap stocks have performed better than the mid and small cap stocks that led the way in 2013. Asia and emerging markets have had a difficult year until recently with the effect of tapering causing many markets to fall back. This has been redressed somewhat in May and June and some frontier markets have had much stronger returns but in general it remains a worry for many investors. Japanese markets have failed to ignite much interest as investors have waited for signs of improving confidence, weakening yen and more central stimulus.

After last year's growth being so strong it was perhaps inevitable that we would see the momentum reduce in 2014 particularly in the mid and small cap areas of the market. What is perhaps more unusual is the fact that bond markets have shown unexpected resilience in 2014 especially in government debt.

Sector Review

UK

There are many positives to take from the current UK GDP figures and the employment rate which has significantly strengthened. The market still requires validation of this in terms of earnings growth but it looks as if the UK economy is on a more sustainable growth path than other European countries. Growth data from the first quarter shows that the UK GDP was 0.8% which is ahead of the US and Europe. This suggests higher interest rates may come sooner than expected which may dampen growth prospects as sterling strengthens.

The market has reacted positively to this growth until around April 2014 when the momentum stalled. The positivity was led by the mid and small cap stocks in 2013 but we have seen this reverse in the second quarter of 2014 when mega and large cap stocks have seen stronger support. This has been partly down to a change in investor's appetite for risk, and weaker economic data in the first half of the year, particularly from China and the US. On a more practical basis stock prices have probably reached fair to overvalued given earnings levels and now require further evidence of higher earnings to move prices forward.

There are some areas of concern - the housing market has become a potential problem to the central bank as it is showing signs of overheating which could hit consumer confidence if a bubble were to form and then burst. So far the housing boom has not been fuelled by excess credit growth - whilst mortgages grew 18% p.a. in the 1980's, and 10% p.a. pre-crisis, the increase over the last three years has been a more modest 1.1% p.a. which explains why the Bank of England measures to contain house price rises have so far been relatively modest. The political situation also becomes more unstable as we get closer to an election in 2015 and also to the forthcoming vote on Scottish Independence may cause instability if the polls suggest a vote for independence is likely.

Europe

European stock markets have lagged the US significantly over the last three years, primarily due to the Euro crisis. The famous Draghi speech guaranteeing to do whatever it takes to preserve the Euro in July 2012 first of all led to a stabilisation in European financial markets and has now fed through into concrete evidence of an improvement in peripheral European economies. In fact, peripheral spread convergence has continued to such an extent that Ireland, Portugal and even Greece have been able to return to financial markets and issue debt. This fall in the cost of borrowing in the periphery means the cost of capital for European companies has fallen, which has helped drive the improvement in European stock markets in the last couple of years.

Economic activity stabilised in 2013 and this, combined with improving conditions in the periphery means that the prospects for growth have improved from initial forecasts with many peripheral countries now running a primary surplus. With fiscal and current account positions improving an easing in austerity programmes has occurred. Domestic demand is coming off highly depressed levels and as a result inflation remains well below its 2% target. The ECB has now acknowledged it may be necessary to ease monetary policy further including the new targeted long term refinancing operations and a potential form of QE. This remains a strong positive for markets but needs earnings to pick up and they remain on a downward trend possibly due to a stronger than expected Euro.

Europe continues to trade at below trend multiples and earnings, and this potential for further catch up suggests that the trends seen over the past 12 months are likely to continue for the remainder of 2014. Peripheral Europe is on a recovery track which looks unlikely to be blown off course outside of a new global recession.

US

The US economy had been expected to continue its rate of acceleration but a harsh winter resulted in activity shrinking markedly during the first quarter. In fact, the first quarter of 2014 has seen the worst performance from the US economy since the recession. As a result, prospects for the first US rate rise have been pushed further out, encouraged by dovish comments from new Fed chairperson, Janet Yellen.

The decline in economic growth has been largely due to what can confidently be stated as one-off factors. There has been a decline in health spending due to Obamacare which was not forecast, together with the effect of very adverse weather and de-stocking. With none of these factors likely to be permanent the signs are that the recovery continues to gain pace - although the first quarter setback means that this year US GDP growth is unlikely to hit the previously expected 3% level.

The US Fed publishes a consensus view of forward interest rates by its members which points towards a Fed funds rate of around 2.5% in 2016. Market expectations are even lower than this, with the most dovish house being Pimco whose peak interest rate predictions are lower than many institutions. Some commentators are more sceptical as the Fed has never tightened as slow in an upswing as current forecasts suggest. Investors are in a low rates world but how low rates will stay over the cycle is open to debate. Even though growth in the US in 2014 will be lower than expected the strength of the recovery continues to gather, with wage surveys amongst small firms forecasting a significant pickup in wages over the next 12 months - this could easily feed through to inflationary pressures and affect rate expectations.

Asia and Emerging Markets

China seems to have successfully engineered a soft landing, with indicators such as power generation and industrial production suggesting the economy has bottomed. Statistics also support the view that a modest re-balancing of the economy has occurred, with consumption growing at the expense of fixed asset investment - for all the talk of slow-down in China, year on year retail sales are 12.5% higher driven by a continued growth in disposable income. The weakness suggested in the regional or shadow banking system continues to provide further uncertainty for investors but this has yet to provide destabilisation in the financial system and is well covered by the country's currency reserves. If anything the government may allow some defaults to flush weaker lenders out of the system.

After the setback to emerging markets in 2013 there has been a reprieve for now, but challenges haven't gone away for all countries. During the crisis, the emerging world continued to grow and as a result, currencies appreciated versus those in the west. In this environment it was unsurprising domestic bank credit grew strongly in some countries. Some countries have announced stronger reform measures than others and India has benefitted from the election of a reform-minded government with a clear majority. For some, lower currencies have translated into increased levels of exports, but this is not the case across the board. The emerging world remains one where economic performances will remain divergent.

Japan

The Japanese market saw some improvement in performance in the second quarter as markets in the region generally bounced back from what were unrealistic valuations. Abenomics First Two Arrows had an instant impact on the yen and the stock market, but the Third Arrow of structural reform will take much longer to fully implement. The economy, which was temporarily squeezed by the sales tax increase, is still recovering from this. Structural reforms need to occur to encourage firms and households to invest and spend and it will take much longer to change the Japanese psyche. Japan however does remain well supported by its central bank and general policy measures. There are some signs that at a corporate level the long process of balance sheet repair is at an end with many companies generating significant cash which is being deployed into value adding businesses and in returning value to shareholders through dividends and buybacks. Some ¥10.3 trillion of profits was passed onto shareholders in 2013 in the form of buybacks and dividends.

Fixed Interest

Chart showing 2014 returns for major fixed income indices:

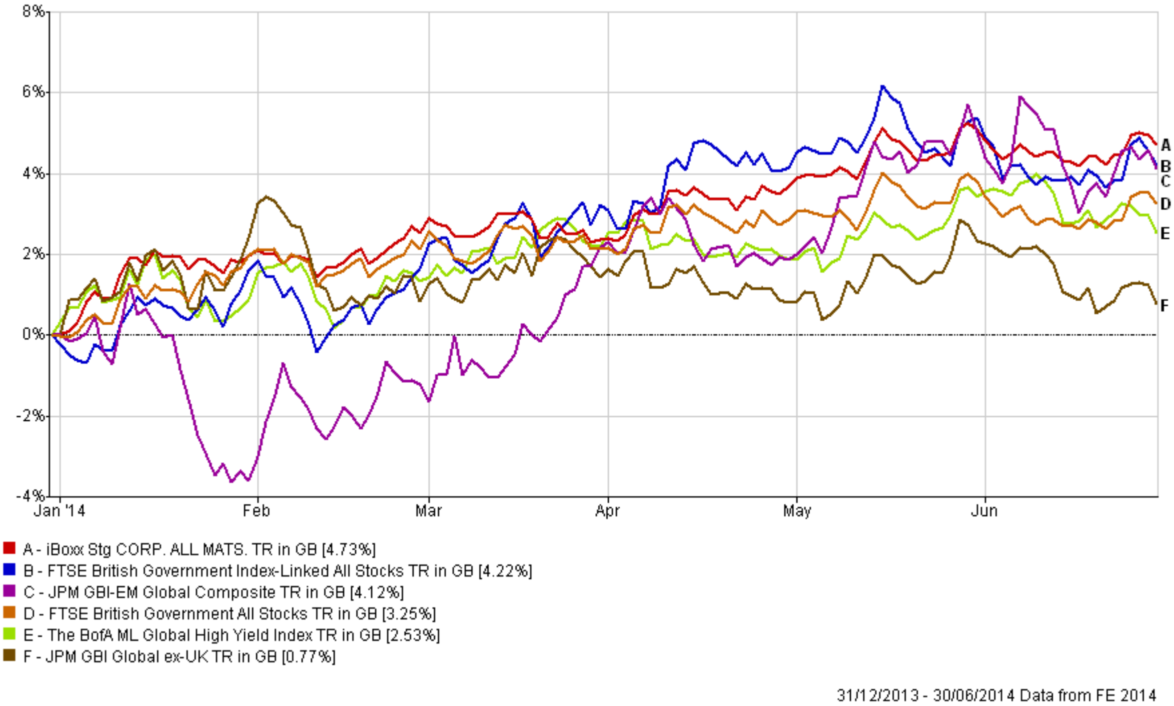
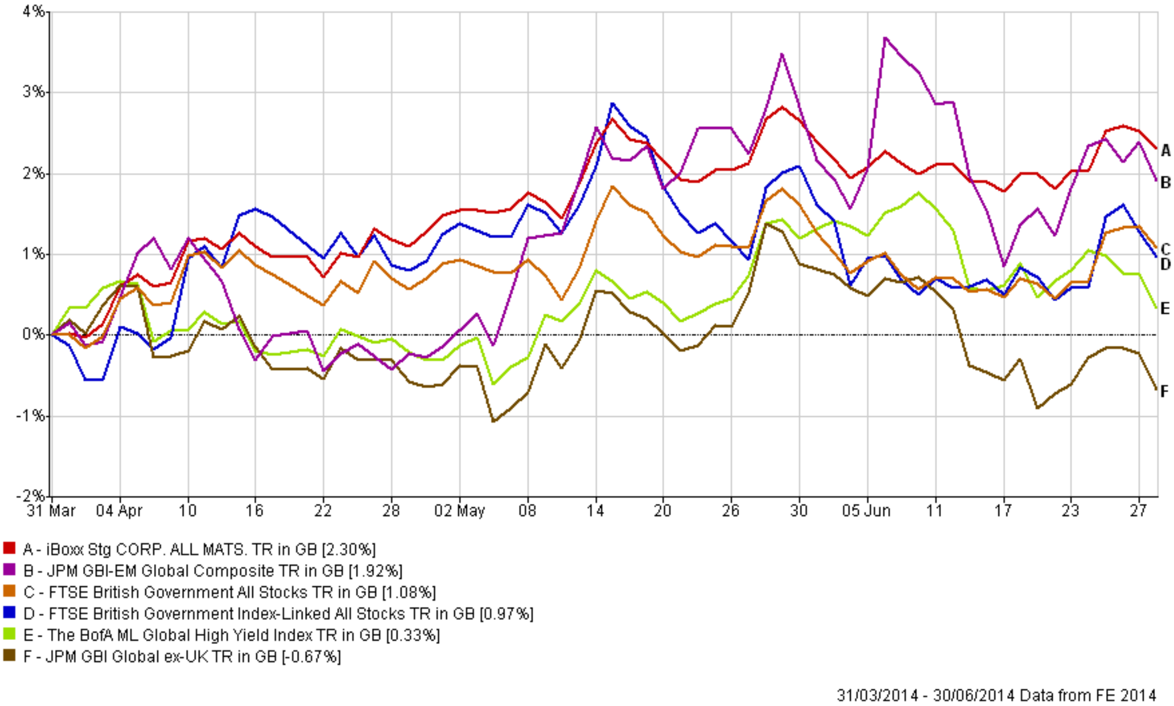


Chart showing quarter two 2014 returns for major fixed income indices:



In fixed interest, markets will have to contend at some stage with higher rates, almost certainly in the UK and then the US and as the impact of QE further diminishes, the demand and supply balance will deteriorate. Structurally, there is support for fixed interest markets due to increased levels of regulation for financial institutions and asset liability matching. Some investors will continue to be forced down the route of buying what are considered safe assets even if value is poor.

In an environment of a gradual economic recovery it is logical to continue to prefer credit to government bonds, although by historic standards valuation in high yield looks expensive. In a low rate world where there is no sign of a pick-up in default rates, high yield will continue to have attractions to investors with a thirst for yield and decent long-term returns from this asset class will now depend on strong stock picking rather than market beta. There have been some pockets of excess in the high yield market, in particular with the re-emergence of covenant-light loans. A manager in the asset class who is able to correctly identify risk versus reward will be vital to generate satisfactory returns.

Overall the likelihood is that over the rest of 2014, core government bond markets such as the US, UK and Germany see a modest uptick in yields. The longer term prospects for these markets will depend on how far interest rates rise. If Pimco's optimistic 'New Neutral' pans out, yields will not rise significantly at the long end from current levels, but deteriorations in expectations on rate rises will hit these markets particularly hard. In a modestly rising government bond yield environment credit seems well supported, with perhaps the biggest threat to investment grade being a significant pick-up in M&A activity which would result in a deterioration in credit quality. For the rest of the year, credit is preferred over government bonds but the returns generated in recent years will not be repeated, at best returns will equate to current levels of income from the asset class.

Property

The recent strong returns from the UK property market are possibly a result of investors looking for an alternative to their fixed income allocation but may also be due to the relative strength of the UK economy. It should continue to be a good diversifying asset class during these uncertain market and economic conditions with returns being driven mainly by the yield, although capital growth returns are now 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. Some investment managers are predicting a double digit return for commercial property funds in 2014 which would rely on continuing economic expansion across the globe.

There is increasing investor interest in secondary markets but individual property selection will remain important here. 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 - although local market factors typically have a larger influence on this sector than for the main equity indices and this should be taken into consideration.

In property securities the REIT market has also performed well and helped to give a positive overall picture for the asset class.

Summary

Markets have benefitted in the first half of 2014 from a push back in the expected timing of interest rate increases. In the US this has partly been driven by adverse weather in the first quarter, together with a dovish stance by the US Federal Reserve. The ECB has unexpectedly eased policy to head off the threat of deflation going forward. The UK stands out amongst developed economies, as the one firmly on a recovery track and it would be surprising if the Bank of England were not the first major central bank to raise rates. As a result, markets have not yet had to face up to the withdrawal of the extraordinary stimulus that has buoyed financial assets since the end of the financial crisis. This may now be more of an issue for 2015 than this year.

We have long argued that valuation at point of entry will be the principal driver of returns over the next decade. It is hard at current valuation levels to argue any equity markets are particularly cheap, although pockets of value do exist. The US is trading above its long-term average valuation, with perhaps the largest concerns being either a potential squeeze on margins, or a faster than expected rise in interest rates. Either of these factors could lead to multiple compression, the corollary of that which has occurred in recent years. It is unlikely in this environment that earnings would grow fast enough to deliver anything less than below average returns to investors.

Outside of the US, valuations appear less stretched and the UK, whilst benefitting from a pick-up in economic growth, will have to deal with higher interest rates and the effect of stronger Sterling on corporate profitability which has resulted in profit warnings in certain sectors.

In the developed world valuations in Europe remain the most attractive, with companies yet to hit peak margins. Since the financial crisis, US earnings are up 28% whilst European earnings have fallen by 37%. So it seems reasonable to argue that there is potential for further and faster earnings growth in Europe than the States. European markets, although having re-rated from their lows have only risen to historic averages and there remains the potential for significant margin improvement.

Asia and the emerging world remain the one area that trades below historic averages. Whilst there are obvious concerns about these regions, such as China and the need for continued economic reform in certain countries, investors will never be able to invest in the region at a discount to historic valuations when the news is good. Even stabilisation, in prospect for the region, can lead to significantly higher share prices as we have seen in the second quarter.

Whilst there is now much greater certainty about the pattern of economic recovery, the greatest divergence of views amongst investors is over the future course of interest rates. This will clearly impact on asset classes with both equities and fixed interest vulnerable to a significant uptick in inflation if it occurred. Once again, even if inflationary pressures increase, this is likely to be a 2015 or 2016 story rather than one that impacts this year.

A further complicating factor is geopolitical risks. The first half of 2014 has seen an expansion of conflicts taking place in the Ukraine / Russia, Iraq and a widening of tensions in the East China Sea to include the Philippines, Vietnam, as well as Japan. Whilst these have not affected markets to date they have the potential to do so, especially if oil supplies are threatened.

After the significant re-rating of both equities and fixed interest assets, this is not the time for investors to go out on a limb in any asset class. The areas where value most obviously exists in equities are perhaps unsurprisingly those where there is less economic certainty such as Europe and the emerging world and these would be the markets where valuation conscious investors would perhaps be best served by being overweight. In the central or base case outcome of continued modest earnings growth and relatively stable interest rates, equities have the potential to move higher over the remainder of the year, with perhaps greater challenges likely in 2015 when the effect of interest rate normalisation is likely to come to the fore.

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