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Quarterly Investment Bulletin

January 2015

General Economic Overview – Quarter Four 2014

The final quarter of 2014 was a more volatile period for both equity and bond markets across the world. October saw a brief dip in markets as a combination of geo-political concerns and weaker economic data led to a fall in equity markets and a fall in bond yields as investors chased safe haven assets. This fall had been predicted by a number of market observers based on the high level of valuations in western markets - it was however temporary as markets recovered for the remainder of the quarter particularly in the US.

Perhaps the biggest surprise of 2014 has been the strength in core government bond markets, together with the returns from investment grade credit. 2014 was expected to be a year of economic recovery and the prospect or implementation of rising interest rates but expectations for rate rises have been pushed back, with the result that core government bonds have delivered much stronger returns than expected. Many fixed interest investors were caught out by this in 2014, holding short duration strategies.

Country wise, Japan has responded to a slowdown which saw a return to recession in the first half of the current fiscal year with even more QE. In Europe economic weakness has resulted in rate cuts, despite the strength of recovery in some peripheral countries such as Ireland and Spain. The core economies, such as Germany, have suffered a slowdown under the influence of slower growth in Russia and the emerging world, together with France and Italy due to a lack of reform.

In other assets, commodity weakness may have been expected but the size of declines in certain areas, such as iron ore and oil, will have surprised many. A further surprise in 2014 has been the strength of the Indian and Indonesian stock markets as both were supposedly part of the so-called 'fragile five'. Both these countries have been rewarded by markets for embarking on the first stages of a much necessary reform process. The US $ will end the year as the world's best performing major currency – perhaps the surprise here is that investors had to wait so long for Dollar strength which had been expected to kick in from the beginning of 2014, rather than mid-year.

Whilst 2014 saw a continuation of the universal adoption of unconventional monetary policy, this is likely to come to an end for the US and UK in the next year. In contrast both Japan and Europe are likely to persist with ultra-easy monetary policies. What this divergence in policy means for markets is unclear and forecasting economies and stock markets is always hazardous - one of the mantras of the investment world is never combine a forecast market level with a time. These days forecasting has an added complication in that the investment environment is one that investors have not experienced before. This economic cycle is different because the recession that preceded it was caused by a financial crisis, rather than a standard business cycle downturn - a balance sheet recession that required extraordinary monetary measures to combat it and turn markets and economies around. In fact, Central Bank policies have targeted higher asset prices as a means of stimulating economic activity although there continues to be huge debate about the success of this policy.

Markets have been relatively buoyant in 2014 but the response from economies has been more sluggish than many would expect. This ties in with the work by Reinhart and Rogoff in their acclaimed book 'This Time It's Different' which explained that markets often recovered faster than economies after banking crises. The implementation of ZIRP (Zero Interest Rate Policies) and QE have encouraged the market to front run the economic cycle. Even now whilst the US and UK are showing convincing signs of economic recovery, Europe and Japan remain very sluggish. In the US

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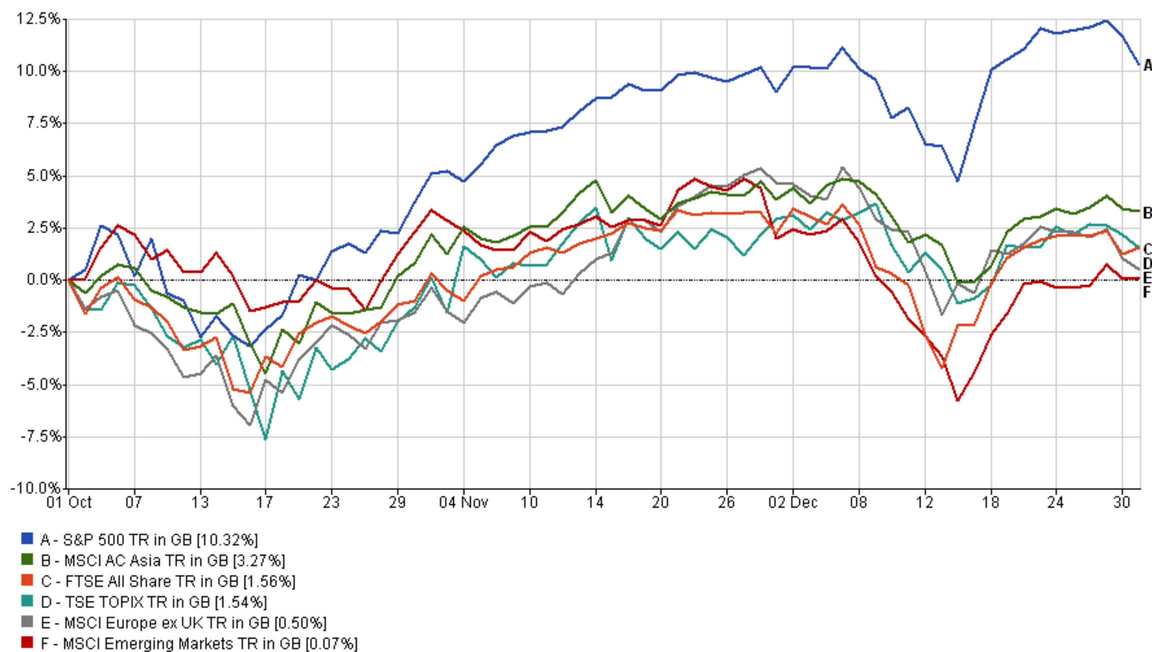
especially, the relationship between these cycles is out of sync - not only is the stock market cycle well ahead of the economic cycle, the monetary cycle is behind the economic upturn. At this stage in a normal economic cycle the stock market would not have risen as much and interest rates would not be as low as they are today in an economy where job creation is now buoyant.

Looking at economic fundamentals, 2015 is likely to see significant divergence in monetary policies. This is because of the difference emerging in economic performance, both in terms of growth and inflation, between the US and UK on the one hand, and Europe and Japan on the other. This policy divergence is a complex issue for equities because markets have risen strongly on the back of expansionary monetary policies that will no longer be adopted universally. In the US, the stock market will have to survive both the withdrawal of QE and at some stage, a rise in US rates. In contrast Europe and Japan look set to provide further monetary stimulus through increased levels of QE in 2015. Investors will look for concrete signs of an improvement in economic growth and a pick-up in inflation in these regions. It is also possible that monetary divergence itself could be the source of trouble. This would be especially true if the US tighten rates aggressively in contrast with the actions of the ECB, which could be akin to driving a car with one foot on the break, and another on the accelerator at the same time.

Equity Markets Overview

Chart showing 2014 returns for major market indices:

Chart showing quarter four returns for major market indices:



Equity markets seem to have paused since the first quarter of 2014 and we have seen a rotation away from the momentum of the mid and small cap rally, returning to the more value driven large cap stocks. One of the factors holding back markets, other than earnings growth, has been geopolitical risk which has been seen in number of areas the latest of which has been in Hong Kong where demonstrations against Chinese influence on policies has recently broken out. The Middle East and the problems in the Ukraine continue to cause uncertainty for investors. Much of this can be seen to be priced in but markets would be sensitive to any further escalations in any of these conflicts. One can probably conclude that market volatility will increase over the next few quarters given these factors and the fact that equity volatility indices have been low for an unusually long period. The weakest markets are those where the greatest uncertainty still exists - areas such as Europe and Emerging Markets.

Looking ahead, the best outcome for markets will be 'Goldilocks' US growth, something not too hot, neither too cold. In the short term markets will be concerned about what is likely to have the biggest influence on equities – a modest contraction in PE ratios or earnings growth. In other words can profit growth outweigh a modest de-rating of markets if bond yields and short term interest rates rise? If the expansion proceeds at a moderate rate, and inflationary pressures are contained, today's higher valuation levels are more tolerable, because interest rates while rising, will remain low by historic standards.

UK

The final quarter has proven to be weaker for the UK market but stable from an economic growth perspective. In global terms the economy is one of the strongest in western markets falling short of the US market but ahead of most European economies. October was a weaker month for equities but the UK equity market produced a strong positive return in November still underperforming the main global equity index. Large cap stocks continued their recent outperformance of medium-sized

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and smaller companies and 'growth' stocks generally outperformed 'value'. The second estimate of third quarter GDP came in at the same as the initial estimate of 0.7% (3% annualised), which maintained the recent trend of reasonably strong growth. GDP forecasts for 2015 are for the UK to be amongst the fastest growing of the G7 economies. This continues to raise questions as to when interest rates may begin to rise but the Bank of England has stated its concerns about the global economy, which may delay this decision until after the election in 2015. The unemployment rate remained at 6% and wage inflation was above inflation for the first time since 2009, although this is partly a function of low inflation.

Market valuations remain not overly stretched but not cheap either. Companies in the FTSE 100 index look reasonably attractive at current valuation levels versus history and versus both mid and smaller caps given the strong returns from the latter categories over the last couple of years. There are headwinds for the UK as government borrowing remains higher than anticipated with more austerity policies required to balance the books. The UK also needs to see stronger numbers from its main trading partner, Europe, before sustained growth can be realised.

US

It has been a strong year for the US economy despite a poor start to the year and some higher levels of volatility in the final quarter. In the US, although the labour market is buoyant, wage growth has remained muted, although starting to pick up in recent months. Overall the economic recovery looks set to continue which should allow the market to navigate its way through a path of moderately higher interest rates. Monetary tightening is likely to lead to some form of US market de-rating so progress going forward is likely to lag the increase in company profitability. In currency terms the US$ will end the year as the world's best performing major currency which took longer than expected to come through in 2014.

Looking forward into 2015 we have to consider market valuation. Today the historic PE on the S&P 500 is around 19x compared to its long term average of around 15x, so the market looks on the expensive side. This can be justified on the basis of the low interest rates we are seeing today, which makes the valuation of equities compared to US Treasuries and cash still reasonably attractive. However, if today's low interest rates are not going to persist, the PE should fall from current levels as has been the case in the past which implies a drag on returns over the next few years, even as corporate profits rise. Overall, levels of profit to the US stock market will face a headwind of a stronger dollar with around 40% of S&P profits derived from overseas sales. On balance US stocks may well be able to rebound from a short term setback induced by the first interest rate rise, but the effect of PE multiple contraction means gains in that market over the next few years could well be less than earnings growth. To some degree the US economy needs to validate the rise in share prices that has already occurred.

The economy will have to balance rising rates and an expanding economy in 2015. Longer term growth is not expected to reach pre-crisis levels as economic conditions are not as strong and the global economy much weaker.

Europe

European markets have continued to struggle due to the divergence in economic capability across the region. There are economies that have shown some signs of recovery this year in the troubled periphery, such as Spain and in particular Ireland, but equally the Greek crisis continues and French

labour flexibility continues to hamper progress in their economy. 2014 was a year of disappointment for those anticipating better economic recovery in Europe - the region continues to be burdened by very high levels of government debt and so far ultra-low interest rates and QE in some form have had limited effect.

In Europe, Germany continues to be opposed to full blown QE also indicating its resistance to proposals to ease the austerity programme in Europe. In contrast to 2010 when the Eurozone crisis first sprung up, the Germany economy is now in a less strong position. Back then its export industry benefitted from growth in the emerging world, both in Asia and from Russia/Eastern Europe with German exports accounting for 40% of GDP. One of its main competitors in capital goods, Japan, is now benefitting from a significantly weaker currency. Germany, out of self-interest, may well at some stage soften its stance on Eurozone austerity programmes which could allow the ECB to embark on further QE, with that institution arguing in favour of an expansion in its balance sheet from €2 trillion to €3 trillion leading to an increase in infrastructure spending. If a better trend in growth in Europe emerges next year, together with lower oil prices, European markets have the potential to make progress.

European investors will also have to watch to see if a rise in US interest rates, even if modest, results in higher European bond yields. The solvency issues of peripheral European countries have been greatly eased by the collapse in the cost of funding. Whilst this is not likely to be an issue next year, it is possible that at some stage in the future, concerns will re-emerge as debt levels in many economies remain high. The situation in Russia remains difficult for Europe, not so much in a military sense, but more the impact of the severe economic slowdown and currency devaluation occurring there. Economic sanctions are hitting Russia hard and it is possible that Putin may try to retaliate, if only to boost internal solidarity over his policies.

Asia

The key economy in the area, and increasingly in terms of world GDP, is China and there has been significant debate about the rate of Chinese growth in 2014 and beyond. The Chinese economy, although slowing, has seen the authorities move to deal with problems in both property and shadow banking. Confidence that a hard landing in China will be avoided would be a positive for all Asian markets next year, however, as the Chinese economy slows to a 'new normal' and fixed asset investment as a share of the economy declines, a rapid rebound in commodity prices looks unlikely. This means investors in the emerging world need to apply greater selectivity, and a passive approach to that region is unlikely to be rewarding.

Asia is a beneficiary of lower commodity and especially oil prices. In contrast, both Russia / Eastern Europe and Latin America as commodity exporters may continue to find the next few years challenging on the economic front. Both housing and shadow banking are obstacles to the economy in China but these alone are unlikely to bring China down. Within the housing market leverage remains low and the authorities are keeping tabs on the situation in shadow banking and trying to deal with problems as they arise. One of the ways of dealing with this is allowing local governments to issue bonds. The central government has the potential to step in and help if difficult situations arise. There is no denying China will see slower growth over the next few years of the 6% - 7% level, combined with better balances within the economy and on environmental issues. It is a positive for Asia that several countries have seen a changing of the guard - India and Indonesia have been beneficiaries of new governments with significant majorities and a reformist agenda which bodes well for the future.

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Emerging Markets

As with the Asian continent, the influence of China in many of the region's economies is significant. The threat of a lower level of growth and a more domestically led economy in China remains a potential negative for emerging market growth prospects as does the recent reduction in US QE, although this has been replaced by Japanese and potentially European QE. Other benefits that should filter through include the opening up of the Chinese A-share market to foreign investors via the Shanghai-Hong Kong Stock Connect programme which is a major positive development and could lead to an increasing number of opportunities to invest in companies with good prospects at attractive valuations.

The Chinese government also plans to expand the development of infrastructure projects to neighbouring Asian countries which will, in turn, help Chinese corporates export their expertise to other countries. There has been much negative market sentiment surrounding disappointing emerging markets export growth, however, investors should not lose sight of the significant underlying domestic demand-led growth in the emerging world. It should not be forgotten that the population of China and India is over 2.5 billion, let alone the remaining emerging countries, and an expanding middle class is driving strong consumption demand and accounting for an increasing share of wealth creation globally. This structural story remains in its infancy and it will continue to create strong investment opportunities.

Further reform is necessary in many emerging economies. It is a positive for Asia that three countries at least have seen a change in political leader. The election of Modi in India with his reformist agenda has sparked a huge wave of optimism and this is an economy which, if managed well, could see an unlocking of potential that will result in a decade long economic expansion.

Indonesia too has elected a new style of leader with President Jokowi embarking on a reform agenda and has already cut wasteful fuel subsidies which benefitted the rich more than the poor. Indonesia has strong demographics and a low cost labour force where there is a huge opportunity to unlock manufacturing potential. A wasteful subsidy system in that country has impaired the ability to develop infrastructure and Jokowi has realised this impediment to growth needs to be removed.

In Latin America, the Brazilian economy has suffered a significant slowdown with growth rates this year below 1% and only a modest pick-up predicted for next year. High inflation has resulted in persistently high interest rates reducing consumer demand. Brazil is suffering from the European disease of too much government and the re-election of president Rousseff has not been seen as positive for a reformist agenda during her second term. Overall, Latin America's dependence on commodity led growth has been a negative although there are examples of economies which will grow for other reasons - such as Mexico benefitting from continued US growth.

The situation in Russia remains difficult for Europe, not so much in a military sense, but more the impact of the severe economic slowdown and currency devaluation occurring there. Economic sanctions are hitting Russia hard and it is possible that at some stage Putin may try to retaliate, if only to boost internal solidarity over his policies.

The emerging market region as a whole remains one where strong country and stock selection will be necessary to ensure above average returns. This region has huge variations in corporate

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governance with only certain companies pursuing shareholder friendly policies. In the past this has been no impediment to excellent returns if the correct fund managers are selected.

Fixed Interest

Chart showing 2014 returns for major fixed income indices:

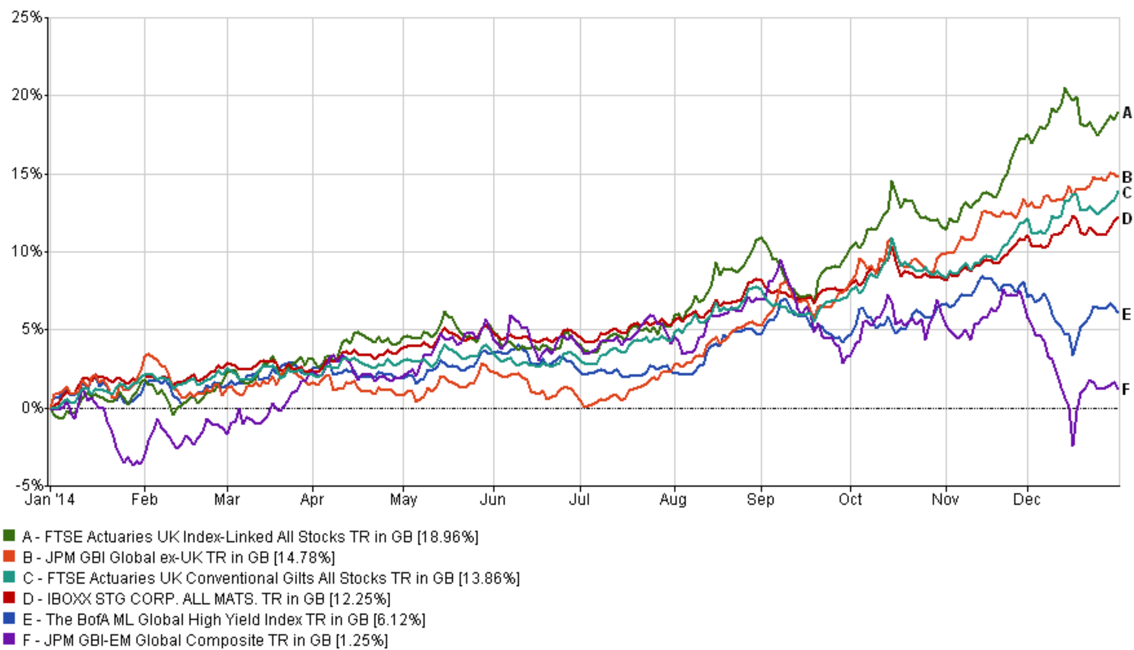
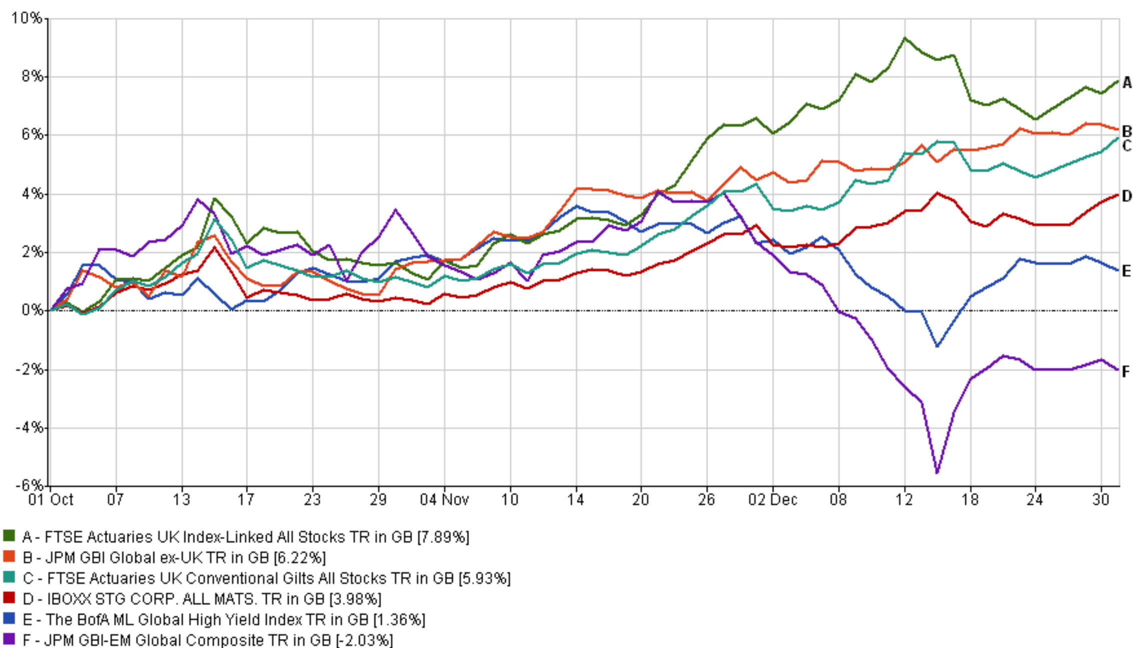


Chart showing quarter four 2014 returns for major fixed income indices:



This area has been and continues to be the most difficult to manage in terms of duration and asset allocation. The position on interest rates has really been one that investors have struggled most with

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over the last year as most had anticipated rises earlier than 2015. The continued strength of bond markets in 2014 culminated in the fall in government bond yields in October which saw many investors lose faith in their short duration strategies which had generally failed in 2014.

The timing of the first interest rate increases in the US and UK have become closer although in contrast, economic weakness in Europe suggests ultra-loose monetary policy will be the norm for longer. The impact of these tensions has been seen in currency markets where the euro / dollar rate in particular has adjusted significantly in 2014 which caused a sell-off in the higher yield end of the market as well, given their higher risk exposure.

The other reassessment that many investors have had to adjust to in 2014 has been the likely peak of this current cycle. What once was thought of as a 5-6% maximum has been adjusted downwards by leading economists to 2-3% because of the fragility of the global growth cycle - this means that the threat of significant capital loss to bond holders is reduced. Investors also need to consider the likely course of events when US short term interest rates do eventually rise. The two previous interest rate cycles of 1994 and 2004 saw shares fall around 10% just before and after the initial hike. Today timing may be different as Central Banks have adopted something called 'forward guidance' which means that the Fed will signal its intentions in advance to manage expectations and as a result any stock market weakness will probably occur earlier than the actual rate rise announcement itself, as markets discount future events. Whilst some sort of setback is likely, this does not mean a market correction will turn into a bear market. In both 1994 and 2004 US equities resumed their rise, even after interest rates continued to increase.

If markets believe a tightening in monetary policy is a normal reaction to an improving economy, not a response to overheating, further progress can be made. Bear markets are typically caused by monetary tightening from an inflationary threat. In other words, at some stages in previous cycles Central Banks have wanted to induce a severe economic slowdown to crush inflation from the system. This is less likely to be the case today, in fact, recent US$ strength will help suppress both growth and inflation in the US economy and moderate interest rate rises. As noted the likely peak in this interest rate cycle is likely to be lower than before.

Holding some fixed interest in a client portfolio also gives protection against unexpected events that result in a setback in equity markets. After the strong gains in markets since 2009 this is not a time for investors to go out on a limb and put all their assets into equities, or any other single asset class for that matter.

Property

The property market in the UK has had a very strong year thanks to an improving economic climate and the strength of the South-East and London markets. Returns from the UK commercial property market remain very strong on a monthly basis and are expected to be so for 2015, as evidenced by recent Aviva forecasts. This could be 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 driven mainly by the 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 is increasing investor interest in secondary markets but individual property selection will remain important here.

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Property securities markets had an extremely strong quarter four, particularly November, led by the US and its double-digit return. The sector continues to be influenced by the outlook for interest rates, as it has been traditionally seen as a good source of income due to a typically above average yield, so the anticipated delay in interest rates has been seen as a positive. The sector will continue to be driven by both the outlook for property and for equity markets in general with investor sentiment likely to be another 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

The returns from equity markets over 2014 have been less momentum led than in 2013 and have shown the need for companies to deliver profits to reflect their market valuations. The continued surprise has been the resilience of bond markets and the fall in yields much against investment consensus for 2014. Western developed markets have seen strengthening economic growth, particularly in the US and UK, whilst Europe has continued to falter but on a very country specific basis.

In a normal economic cycle, investors could expect better returns from equities going forward as markets would not have run so far, or re-rated so significantly from their 2009 lows. One of the consequences of unconventional monetary policies has been that markets have front run the improvement in the global economy. At best, outside of the US, markets are fair value.

The more recent economic growth patterns have seen divergent economic recoveries and divergent expectations on monetary policy and so volatility has increased. Investors should not expect a change to these more recent patterns in 2015. In the US, although the labour market is buoyant, wage growth has remained muted, although starting to pick up in recent months. Overall the economic recovery looks set to continue which should allow the market to navigate its way through a path of moderately higher interest rates. Monetary tightening is likely to lead to some form of US market de-rating so progress is likely to lag the increase in company profitability.

Any sign of a sustainable pick up in Europe and Japan could see a positive response from their stock markets. In these economies monetary conditions, a weaker currency and lower oil prices all give the possibility of a positive surprise next year. The Chinese economy, although slowing, has seen the authorities move to deal with problems in both property and shadow banking. Confidence that a hard landing in China will be avoided would be a positive for all Asian markets next year.

Fixed interest markets have been one of the positive surprises for investors in 2014. Interest rate rises in both the US and UK have been put off, whilst markets have now factored in lower rates in both Europe and Japan. 2015 could be more challenging for government bond markets, although the fragility of the recovery and aftermath of the GFC, means rates will stay much lower than peaks of previous cycles.

Globally, there is still too much debt, especially in the West, and deficient demand. Investors continue to place considerable faith in the ability of Central Banks to manage the global economy out of this situation and put the world onto a footing for sustainable growth.

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Investors need to be aware of potential risks, as well as potential returns, when positioning portfolios and so portfolio diversification with some hedges against adverse outcomes is advisable. Investors should not be concerned that these hedges do not all work at the same time, the point is that they protect the portfolio against different outcomes – without them the portfolio would only do well if the central outcome came to fruition. Whilst this remains the base case, it is not an absolutely certain one. To hedge against adverse outcomes investors should consider holding some cash for short term opportunities (optionality), retain exposure to selected fixed interest markets, and look to include some absolute return funds that have delivered positive returns in years when markets have delivered a negative outcome. Investors will also need to consider what they care most about, losing money or missing out on an opportunity.

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