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Quarterly Investment Bulletin

April 2015

General Economic Overview – Quarter One 2015

The first quarter has seen positivity in equity, bond and property markets with some increased volatility creeping into all asset classes. Our review of the individual sectors and markets highlights the specific issues for each but in general we can point to the positive effect of a very accommodative global monetary policy - we have seen lower interest rates in twenty countries across the globe in recent months, including expanding economies such as India.

The continuation of the strength of bond markets has been more unexpected as we felt that yields would rise in anticipation of forthcoming rate rises in the US but this has not happened. Initially these potential rises were pushed further out as US data weakened in the first quarter, and then many of the remaining global central banks reduced rates or, as was the case in Europe, sought to expand the money supply through QE. This injection plus that of Japan has effectively replaced the loss of the Feds QE that ended in 2014. The only real areas of weakness have come in emerging market debt and some areas of the high yield market.

As a generally observed trend it would seem that investors have preferred those areas with some form of QE ahead of those without it in the quarter, although this has been supported by valuation criteria and some fundamental structural changes in these economies.

In equities we have seen a turnaround in the areas of strongest return with the US and the UK delivering weaker market growth than Asia, Japan and Europe. Emerging markets were also ahead this quarter but this was not universal as Latin America was a weak spot in the region. Any commodity based exporting nation has struggled economically of late and many of these countries lie in this region.

In the US the economy has continued to expand but the more recent data points to this slowing down which is one of the reasons why we have not seen any rate rises. Looking further into 2015 the bullish story on US equities does remain intact but returns are likely to be more muted as earning growth normalises and the dollar strengthens. The rest of the globe needs to start catching up however or the US could get pulled back.

Elsewhere the UK continues to grow but the forthcoming election has begun to dominate investors considerations. The Asian region has performed well within Emerging Markets but this performance was bettered by Emerging Europe. The Russian equity market performed well over the quarter as a whole, albeit with very high levels of intra-quarter volatility. Latin America again performed poorly primarily due to Brazil, which saw increasing inflation and interest rates and no significant movements on required reforms. Europe's equity markets continued to recover thanks in part to QE but also because of relative valuations attracting investors and improving news from some peripheral countries such as Spain and Ireland.

In some ways the threats have not changed from those at the end of 2014 in that a divergence in monetary policy across the globe could lead to differences in economic performance in both growth and inflation terms. The continued stimulus in Japan and Europe in contrast to the potential tightening in the US will at some point cause issues for equity markets across the globe.

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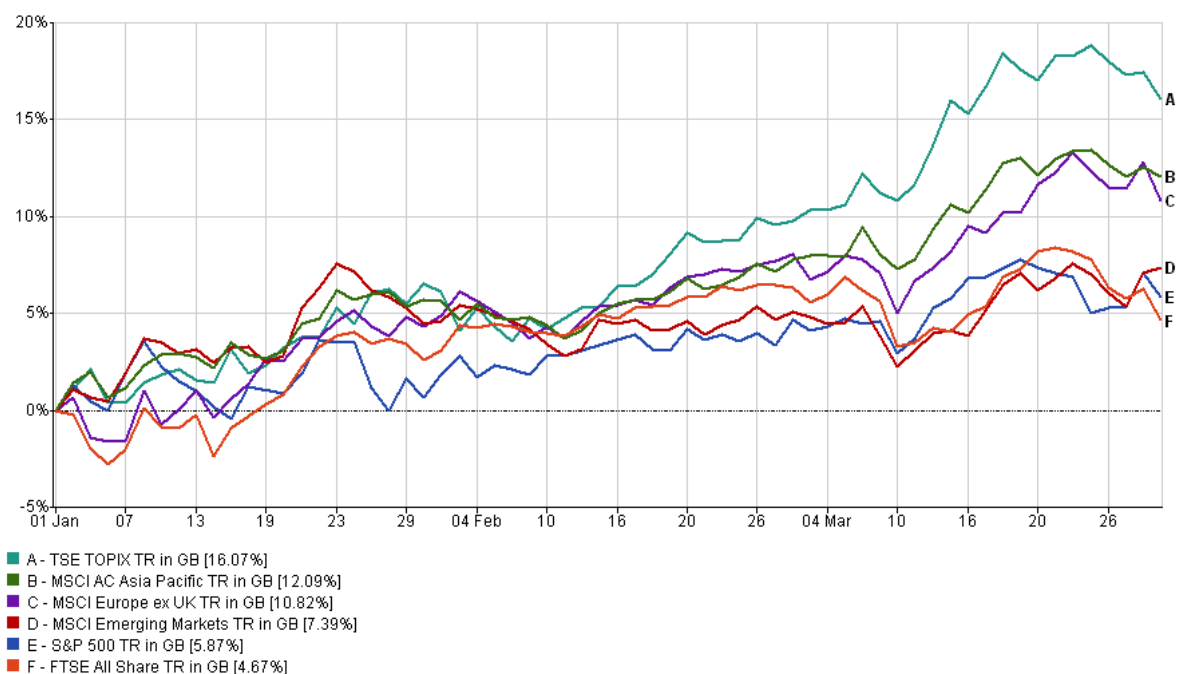
Equity Markets Overview

Chart showing 2014 returns for major market indices:

Chart showing quarter one returns for major market indices:



Equity markets have shown continued strong growth in 2015 which has been a surprise to a number of commentators as slower market growth was predicted, given the momentum of previous years. Overall the strongest market growth was seen in Japan where the stimulus package and encouraging company reform has seen both external and internal investors return to the market. This has been mirrored in Asian markets which have also seen stronger growth in areas such as India and Indonesia but also, in market terms, from China which has seen the new Connect service boost the A shares market.

Europe has benefitted from investors looking for value in markets which have underperformed relatively during 2014, and has seen some re-rating in 2015. As global economic growth has improved, the introduction of a QE package from the ECB in 2015 has improved market sentiment particularly as data from the peripheral countries has shown increasing strength. The UK and the US have seen weaker relative market growth in so far 2015 but both economies continue to produce consistently improving data. The momentum of the US market in 2014 was likely to slow down at some point given the data improvement was slowing down and other countries were beginning to look better value for investors. 2015 has also seen a return to growth stocks in more mature markets as investors look to more cyclical opportunities. The weakest areas continued to be within emerging markets and more specifically Latin American countries such as Brazil which was down 11% on the quarter in sterling terms.

UK

The UK continues to improve economically and can only benefit from the improvement in Europe – our strongest trading block – which is being led by Germany. The market has reached levels not seen since 1999, and broke through the 7000 barrier for the first time earlier in the year. Whilst a good sign for improving confidence the market has since fallen back to below this level. The second estimate of fourth quarter GDP confirmed the initial 0.5% growth figure, which is still a fall from the previous quarter. Forecasts for 2015 and 2016 continue to be positive and have been revised upwards by the Bank of England and the CBI. January PMI data was strong across all sectors and seems to support this optimism and unemployment continues to fall, reaching a 6-year low. Headline inflation continues to be influenced by the significant fall in the oil price, and dropped to its lowest level on record with RPI also falling by a reasonable margin. Mark Carney commented on the effects of low inflation / deflation and that this could turn negative in the next few months, but also that the 2% target should be reached in a couple of years. The Bank of England would like to start the process towards normalisation of rates but these figures are a good excuse to delay this further, although wage growth has shown signs of reasonable improvement. The market is likely to become more volatile in coming months as we head closer to an election which at the moment seems unlikely to deliver a clear result. More uncertainty may follow if a vote on Europe takes place should the conservative party be re-elected.

US

Although the markets have not been as strong this year, economic data continues to be positive with jobs being created at a faster rate than many commentators had expected. GDP growth forecasts have been lifted although perhaps not to levels expected at this point in the recovery cycle indicating that it may be a slower return to normal levels of growth. More encouragingly, the levels of mergers and acquisitions have this year reached their fastest start since 2007. Healthcare groups have led the way with Pfizer, AbbVie and United Healthcare being the leaders in a range of deals worth $95bn so far in 2015. The telecoms sector has been equally supportive of this trend with a number of mega

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deals waiting for US regulatory approval. Overall this is part of $811bn worth of deals globally, mainly centred on the US. This is a good sign of corporate confidence and also of cheap finance and a shrinking pool of quality assets.

The second estimate of Q4 GDP was revised downwards, although the reasons for this were not concerning and the key areas of consumption and business investment were strong, supported by strong growth in the services sector. Employment continues to be strong with previous figures revised upwards and January proving to be another good month. Wage growth shows signs of picking up. There are some risks such as the continued strength of the dollar which could weaken exports further and the reducing effect of shale oil and gas as new production becomes less economic at current oil prices.

Given this strong data the focus remains on US interest rates and when they may begin to rise. The Federal Reserve is reluctant to commit to any time scale but they are looking at returning interest rates towards a more normal level but any rate rises are likely to be very gradual initially. Janet Yellen has expressed the desire to remain patient but to decide the course of action on a meeting-by-meeting basis. This may continue to cause shorter-term volatility within equity markets. The US remains the strongest of the Western economies but will require global growth to improve if GDP is to continue to grow at over 3%pa.

Europe

The strength of the European markets has been one of the more surprising aspects of the year so far given some of the structural problems that the EU has to face in turning around its economic malaise. Certain countries at the core are doing well such as Germany but even here there are constraints because of a lack of unity on policy issues. There have definitely been improvements in some of the peripheral economies and this has been boosted by the recent actions of the ECB - the long awaited QE injection for the Eurozone was finally started in March but this had generally been factored into the markets before bond purchases started. Other factors came into play at the same time including the fall in the oil price which has helped put more cash into the consumers pocket and also has helped the European automotive industry improve expectations after a number of years of decline.

Inflation has been a worry for many in Europe and now that it is effectively zero, the issues for indebted countries seem to have increased. Part of this is the effect of a decline in commodity prices including oil but this will fall out of the statistics later in the year giving a more realistic picture. The other key factor in Europe’s improving economic position is the declining value of the Euro which has been a positive for many European exporters in the last year, especially for those companies selling in dollars.

Overall the belief in a European recovery is strengthening with both consumers and fund managers increasing the weighting to their portfolios.

Asia

Asia has been a strong area for investors in 2015 with China being the strongest market of all returning 13%. This is more a reflection of valuations coming into line with other Asian markets rather than China showing improving economic growth, indeed data indicates that growth rates are declining as a number of issues are resolved in the domestic economy. The issues are well

documented in that there has been a housing bubble in the economy which is being slowly resolved as a process of deleveraging takes place across the economy. Equally China is not benefitting as much from global improvements as a more domestic led economy is developing and so the export led growth of the 1990s and 2000's is unlikely to be repeated. The declining commodity requirements of China has hit parts of the region such as Australia more strongly.

India was the strongest economy in 2014, and it moved into with significant momentum behind its improving structural and infrastructure reforms under new premier Modi. The most recent budget report suggested a significant increase in infrastructure spending with a target to increase capital expenditure tenfold in 2015. Plans are in place to build 100,000km of new roads and five new power utilities in addition to a five year modernisation of the railway system. A lower corporate tax rate and lower interest rates are part of this pro- business expansion.

Generally across Asia accommodative monetary policy is being adopted with Korea, Thailand and Australia all cutting interest rates in the first quarter.

Asia is continues to be 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.

Japan

The strength of the Japanese stock market has been more obvious over the last year than the BOJ's policies to drive up inflation. The issue for Prime Minister Abe and his team is that they are fighting a losing battle against falling commodity prices which is difficult to change. The silver lining in all of this is that corporate Japan has been more successful in instigating change to meet this changing environment. There have been significantly increasing levels of foreign investment into Japan in the last few months thanks to the realignment of the companies to focus on shareholder value and return on investment and capital employed. The increase in share buybacks has also been a positive sign as well as the willingness of Japanese companies to apply wage increases for workers. Interestingly the weakness in the yen, which has been part of the central policy of the government, has been effective but is not now what is driving investors in Japan. The weak yen / improving stock market bet often used by foreign investors has weakened as investors have found other reasons to invest in Japan.

Emerging Markets

Emerging markets have had a mixed picture over the first quarter but as a region overall they have performed better than they did in 2014 and ahead of the US and the UK in sterling terms. This is mainly thanks to the improvement in markets such as Russia which has had a very strong rebound in 2015 taking the rest of the eastern European markets with it along the way. The areas of the market that continued to do poorly were those in South America, particularly Brazil and other areas of Latin America. Brazil has had a period of high interest rates and high inflation at the same time as suffering from a slowdown in its commodity based economy. The new government is not seen as reformist and therefore it faces an uphill struggle to reposition the economy. 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 strong dollar has also been a headwind for many emerging markets which have currencies linked to it and this may get worse before it gets better as consensus suggests a stronger dollar in 2015. Those countries with significant c burdens may also struggle more than those with very low debt to GDP ratios. One positive for energy importers (such as India) is the reduction in the oil price, conversely the opposite is true for exporters like Venezuela. A number of frontier markets have performed well in recent quarters including Nigeria Egypt, Ghana and Costa Rica.

The key drivers of corporate profits in EM has been from the primary commodities such as oil gas and mining so it is not unexpected to see the area struggle in a declining environment for these assets. Finding returns in this environment it is not as simple as it has been historically - idiosyncratic opportunities need to be sought out across the region, rather than just grouping countries and companies in an homogenous fashion. The EM investor needs to consider each country on its merits, its currency position and its corporate opportunities to ensure competitive returns.

Although it is improving, the region still has large variations in corporate 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:

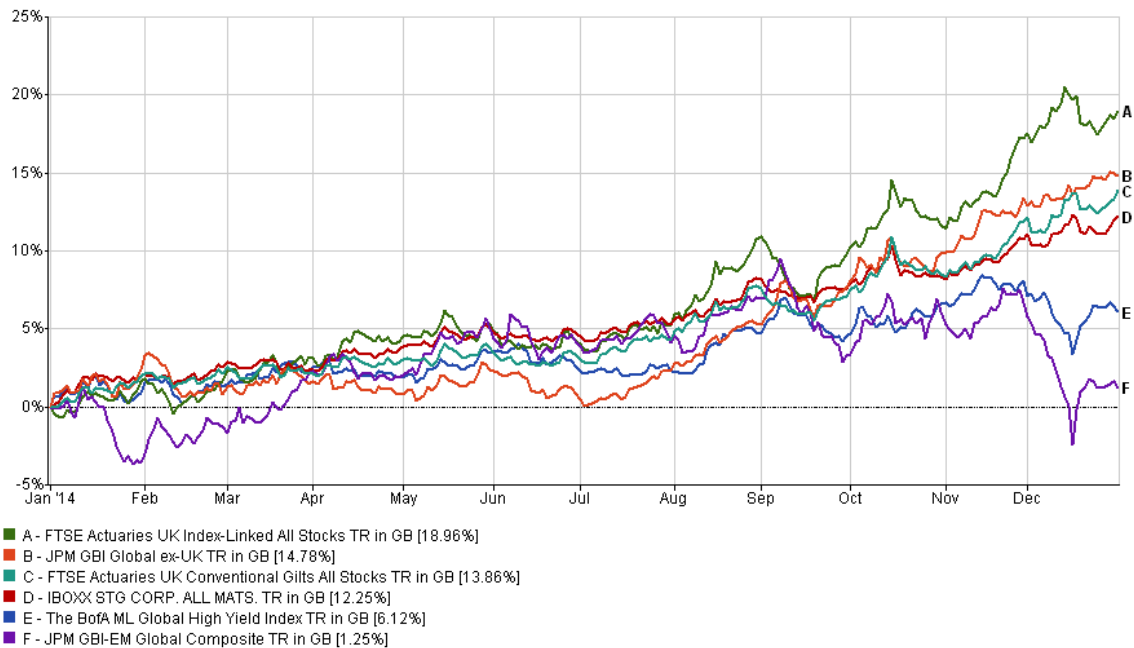
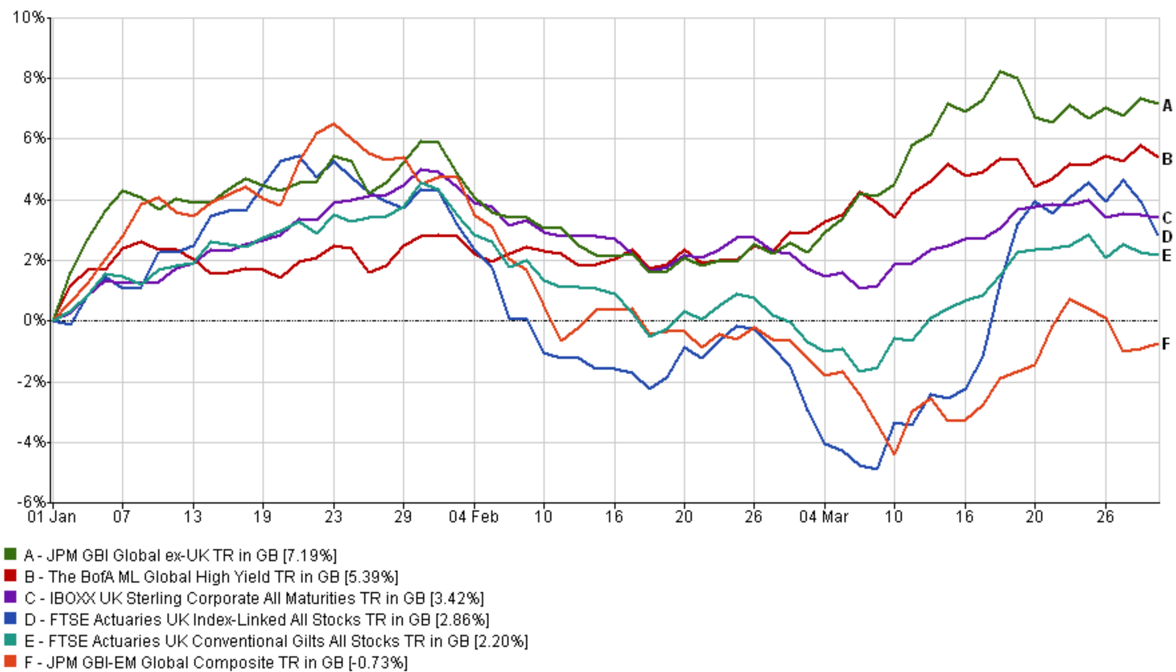


Chart showing quarter one 2015 returns for major fixed income indices:



The majority of fixed interest asset classes had a positive first quarter which was a surprise for the general consensus of investors. The debate about when interest rates will rise in the US has somewhat clouded the fact that we have seen interest rate cuts in 20 countries around the globe in what can be seen as a global wave of accommodative monetary policy. The most significant was clearly Japan and more recently in the Eurozone with the entry of the ECB. With this backdrop it is not surprising that we have seen bond yields remain stable or fall in some cases. The threat to Europe of deflation with negative inflation and negative bond yields is one of the most concerning aspects of the current situation hence the reason for the QE program this year, in the hope that it can stimulate growth and then inflation. Although the European programme is large at over €1.2trn, it is only 10% of European GDP compared to 20% in the US and 50% in Japan so it may be that QE2 in Europe may be needed. An environment of low interest rates, a low Euro, low oil prices and QE may be enough to drive the economy of Europe forward without all of the structural and fiscal alignment being in place.

As usual in the US, the focus is on the Fed and the potential date for rate hikes which have taken a further step back this quarter due to weaker employment numbers. The Fed may feel recovery is more fragile than the GDP numbers currently state and is reluctant to tighten too early in the cycle. The strength of the dollar has helped to push this process further out but the debates between the doves and the hawks in the coming months will be interesting. The longer term rates in the US (10 year 1.91%) are still much higher than say Germany (10 year 0.18%) so US treasuries still benefit from the support of institutions and pension funds looking for quality and decent yield spread. This may lead to a flattening of the US yield curve in coming months.

The only area that has shown recent weakness has been emerging market debt and US high yield, led mainly by the troubled energy sector. The European high yield market has been much stronger but spreads are looking very tight with potentially better value now in the US. The market may suffer if and when rates go up but historically can perform better than investment grade bonds in this

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scenario. In EM debt the weakness of the oil price and uncertainty in eastern Europe and their currencies has seen yields rise. There are still some pockets of strength - particularly those countries with low debt to GDP ratios.

In summary this quarter government bonds, investment grade and European high yield corporate bonds all performed well but emerging market debt continued to struggle. Long-dated assets in the UK again outperformed, as expectations as to when interest rates will rise were pushed out even further.

Property

The first quarter of the year has continued to show that the recovery in 2014 was from a robust base and this has continued in 2015 although more on a global basis than in the UK. The REIT market had a setback in February in both Asia and the US as it is more sensitive to likely rate changes. The UK commercial property market continues to produce good, consistent positive returns but with January's return slightly below that of previous months. The office and industrial sectors have continued to lead the way with the retail sector lagging behind, although the absolute numbers were still strong.

Returns from the direct property market are expected to remain strong during 2015, although the absolute numbers are likely to be lower, as investors are still looking for an income alternative to their fixed income allocation but this 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 may remain strong over the short-term. There are continuing 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.

Summary

For a number of quarters we have commented on the resilience of bond markets and this theme continues in quarter one. Although we had some increase in yields mid quarter, bonds soon rallied as further global QE came on stream and US data weakened suggesting that any interest rate rises would be postponed to later in 2015 or early 2016. Positioning portfolios for a rise in rates still seems sensible at this point in the cycle given that further rate falls are likely to be limited with rates already extremely low historically.

The actions of Central Banks, resulting in the low levels of government bond yields, has made it an extremely difficult environment for many investors causing valuation distortions of all financial assets, not just government bonds, but also equities and property. Equities can justify a high level of valuation while interest rates remain so close to zero, with the hunt for yield and return forcing some investors into higher risk assets than they are naturally suited to. Any reversal of easy monetary policy by a significant degree could lead to these investors heading for the exit all at once. Care is therefore needed in monitoring volatility and market sentiment.

More generally the continuation of QE has also helped equity markets as an easier monetary climate is better for business and promotes capital expenditure and expansion. Low interest rates and falling commodity prices have also helped to put money in the consumers pocket boosting their potential

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spending plans. There are still some attractively valued markets around the globe but many have seen over five years of upward growth leading to close to fair valuations. Asian and emerging market equities continue to look attractively valued both on an absolute and relative basis but with different countries at different stages of reform and development it remains important to be selective in choosing which stocks, sectors, countries and currencies to invest in. Historically, good active managers have been able to add significant value in these regions and the multitude of markets and companies available to invest in and we see no reason for this to change. 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.

Overall investors should continue to hold a diversified portfolio – the unprecedented market environment makes it difficult to understand which asset classes would respond more negatively to changes such as monetary tightening. After the run up in equity market valuations it is possible that equities could suffer more than bonds in a sell off over the shorter term at least. The equity markets with the best potential remain those where profits versus previous peaks remain depressed – Europe, Asia and Japan. The US market has underperformed for the first time since the 2009 rally as investors have concerns over the impact of a strong Dollar on US company earnings and US equities are likely to lag a positive economic environment as this market has seen a significant re-valuation since its trough.

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