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Quarterly Investment Bulletin

July 2015

General Economic Overview – Quarter Two 2015

The earlier part of the second quarter saw broadly flat returns, after a reasonably strong start to the year, but the latter part of the quarter has been dominated by events in Greece which have affected most stock markets around the world. In terms of economic activity there has been a cut in expectations of global growth with data being less supportive of improved earnings especially in terms of top line growth. The US data from the first quarter was weak with much being attributed to the poor winter. Data has subsequently improved in the US leading investors to factor in US interest rate rises later in the year. Elsewhere, the slowdown in China seems to be continuing - at least in terms of fiscal and infrastructure spending - increasing pressure on commodity prices and leading to downturns in commodity based economies such as Brazil and Australia. Latin American economies are also struggling from the strength of the US dollar.

Fixed interest markets saw yields rise over the quarter as the rate tightening cycle looks closer, but there were other factors that added to the move up in yields which saw the 10 year German Bund yields rise above 1%. Economic data in Europe more generally has seen some improvement, with inflationary expectations increasing, as well as a correction to the stance that yields can only fall as QE takes the uncertainty out of markets. The problems in Greece have not had as much of an effect on prices as may have been expected in what is still a relatively fragile environment.

Whilst deflation has become headline news in the media, the global economy is currently benefiting from good deflation, where in most countries wage growth is ahead of inflation, which is allowing a boost to consumer spending. As global debt levels remain high, growth is likely to remain constrained. Although the price of oil has increased this quarter it remains at very low levels and is still acting as a boost to global demand. Ironically, if Central Banks were able to quickly achieve their wage and inflation targets, monetary policy would be tightened and a market de-rating would be likely. The current environment of sluggish growth and extremely low interest rates is supportive of equity markets.

Central Bank policy will remain helpful to equity markets over the medium term as, even in the US and UK where rates are likely to rise first, the level of increases will be shallow by the standards of previous cycles - the economic recovery continues, but remains torturously slow. This is leading to benign monetary policy which is supportive of financial assets.

A new recession would hit public balance sheets hard in an era of ageing western economies. Central Bankers realise the world cannot afford a recession, which explains their ultra expansionary policies. It is quite possible that post the financial crisis there will be a 10-year muted economic recovery with new normal growth at a lower level than seen in previous decades. There remains a need for productivity to increase if economic growth is to re-accelerate.

After the gains of recent years, earnings need to catch up. Valuations, particularly in the US are not cheap. This year, the previous laggards of Europe and Asia have caught up in terms of market re-rating. Markets where there is still scope for profits to recover and/or monetary policy remains supportive are likely to perform best. The timing of a return to interest rate normality will not be uniform with the US and UK likely to raise rates significantly ahead of Europe and Japan.

Equity Markets Overview

Chart showing Q2 2015 returns for major market indices:

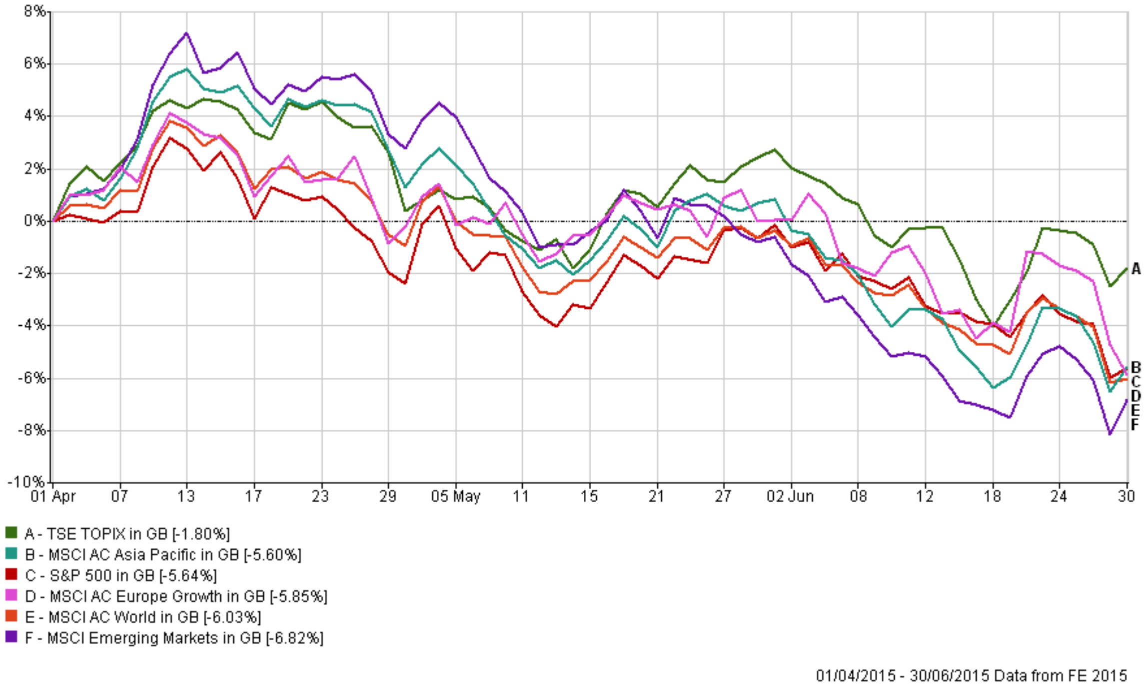
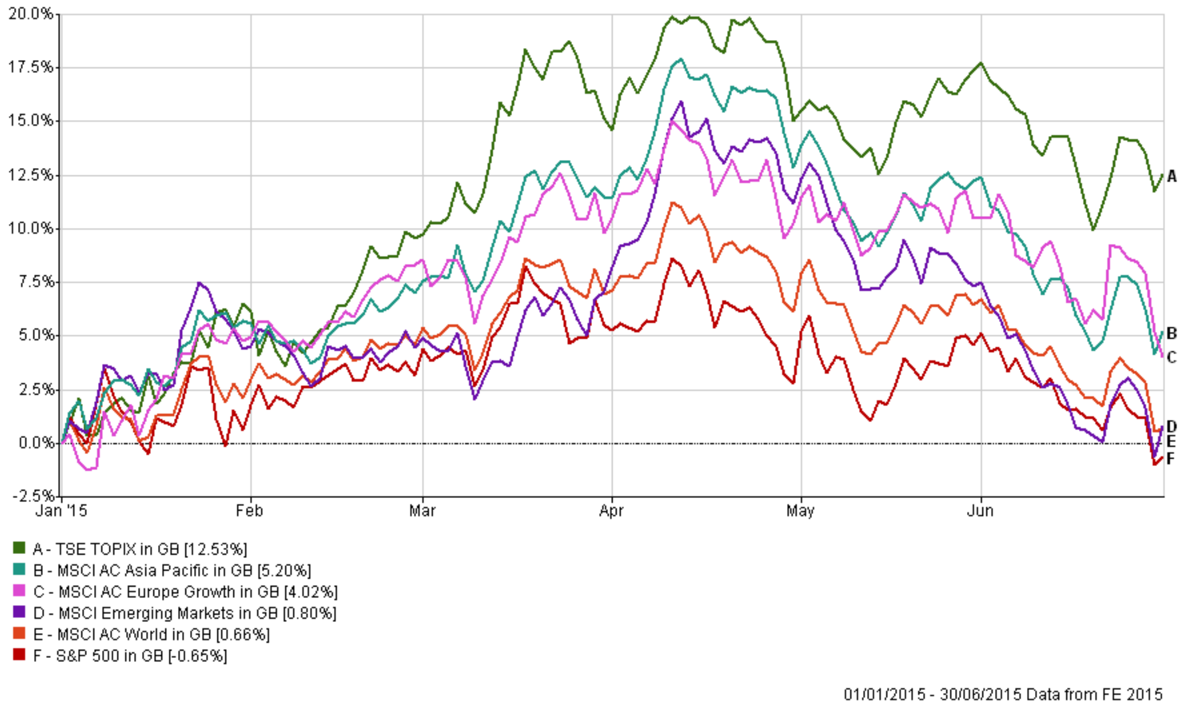


Chart showing 2015 year to date returns for major market indices:



It is not surprising that markets have seen a slowdown in momentum since the end of the first quarter as data has weakened, particularly in the US and China, whilst in Europe the focus has moved to the issues in Greece. All major equity markets were in negative territory over the quarter with future earnings prospects on a downward trend leaving investors more concerned than at the beginning of the year.

The strongest market in sterling terms has been Japan despite the weakness in the currency. The huge levels of QE have continued to support the market but inflation remains stubbornly low and the structural reforms needed to embed this change into the economy are slow to take effect, despite the fact we are seeing wage growth in certain sectors.

It is more than likely that we are entering into a period of muted market growth as investors adjust to a slower growth environment. It is also likely that we will see greater volatility around a level established for markets at the beginning of the year - in the case of the FTSE, around 7000. Market earning expectations have been on a downward trend and it will take a reversal of this plus some demonstration of earnings growth from the top line to encourage investors to expect further dividend improvement.

UK

The election came and went in May with a surprising result but one which ensured political continuity and what was seen as business friendly government. The economy in general seems to be in good shape with unemployment continuing to fall and company PMI indices indicating increasing confidence. Real wages are increasing again as nominal wages increase and the cost of living falls. Data shows that jobs growth continues to increase, rising by 1.8% over the year to Q1 2015 and GDP growth is forecast to reach 3% by the end of 2015.

The bond proxy stocks, as they are now described, have had a more difficult period suffering on the speculation of rate rises - this includes pharma and beverage stocks and those in more defensive sectors. This has led to more attractively valued domestic mid and small cap stocks revaluing. The market saw negative returns over the quarter with the FTSE 100 down just over 2% due to the sell-off in larger cap stocks as well as the continuing instability created by Greece. The sense is that we are range bound at the moment with a demonstration of earnings upgrades needed to deliver some positivity to both domestic and global markets. The UK election result was a positive for markets initially but it does mean more fiscal austerity and is potentially a cause of investment delays as business waits for clarity on the European vote.

More broadly the stability now created since the election also means the government can invoke its austerity and spending plans which could be a drag on economic performance in coming years if growth weakens. This is not the central case for the UK economy but a further recession in Europe for example would weaken the UK economy as well.

US

The early part of 2015 saw concerns about the rate of global growth which was reflected in a significantly lower oil price and the US seeing negative growth in the first quarter. Part of the slowdown in the US economy was weather related, with also a port strike on the west coast damaged economic activity. Many economists also believe that seasonal adjustments understated the rate of economic growth in the States during the first quarter. More recent US economic data has shown a stronger economy with jobs growth moving above the 200,000 per month level in non-farm payroll numbers, together with a pickup in housing construction. Over the remainder of 2015 the lower oil price is likely to continue to benefit the consumer. The US economy is likely to prove resilient over the remainder of the year and continue to lead the developed world through a relatively weak part of the recovery following the financial crisis.

The most consistently debated point is the eventual timing of US interest rate rises and it is this which drives much of the sentiment around the moves in the market. US growth has been affected by the weak start to the year but momentum has returned and GDP figures are being revised upwards. The conundrum for Janet Yellen has been how to manage the communication process around the eventual rate rise - forward guidance has been a positive development, but has meant that every word from the Fed has been debated for indications of when, and by how much. September looks most likely, and gradually seems to be the method. The US needs higher rates to have ammunition for the next potential downturn.

Europe

Europe has continued to be on an improving trend in relation to the overall global economy, despite the obvious recent effect of the Greek crisis. Whilst Europe struggles to deal with the issue of maintaining Greek participation in the Euro many other areas previously in recession have started to turn the corner, including Ireland and Spain. The European economy is also a beneficiary of lower oil prices and has now seen the benefit of lower funding costs for banks. Actions by Draghi and the ECB have seen a significant fall in the cost of borrowing in peripheral European countries which has aided a rebound in economic growth. These countries have also in general become more competitive and are now seeing a rebound in economic activity ahead of the core. Overall economic activity in Europe is surprising on the upside, as QE has not only lowered borrowing costs, but also resulted in a significant weakening of the Euro which has aided international competitiveness.

The most recent sharp sell-off in Bunds saw yields rise significantly and caught many by surprise. There are several theories - some based on technical factors and others on improving data including earnings, but no one theory is definitive. The effect on markets was to see a small fall (prior to Greek issues) in sectors and stocks that were performing well such as healthcare and the bond proxy stocks. Less surprisingly energy stocks did better on a lower oil price and being already lowly rated.

Asia

Exposure to Asia continues to allow investors access to one of the fastest growing regions in the world. Within the overall region growth rates vary, with some economies such as Australia and China slowing, whilst countries such as India are seeing a return to higher levels of growth. Investors should not confuse GDP performance with stock market returns and parts of the region where monetary conditions are being eased have generated some of the strongest returns. Much of Asia, even after the gains of recent years, remains in a catch up phase with the West in terms of economic development. The potential for continued strong productivity growth and improvements in ROE at the company level mean this is still a region with the potential for strong returns. The funds we suggest will seek to benefit not only from growth within the region but also from the self-help stories at the individual company level.

Markets in Asia have outperformed the global market over the last 12 months. In 2014 India was a key driver of returns based on the election of Modi and his reform agenda, this year China has been the strongest performing market. Whilst sometimes overlooked, reforms are continuing in China across a wide range of industries and at the overall macro level. This, combined with an easing of monetary policy with interest rate cuts, has encouraged liquidity to flow into the Chinese market, making it one of the world's strongest performers year to date. Despite the rally in Asian markets over the last 12 months the region as a whole still trades at a significant discount to developed markets.

The lower oil price and monetary easing are tailwinds across some of the large markets in Asia including both China and India as are the ongoing and anticipated structural reforms in these two countries. In China, policy makers are acting swiftly to reduce the burden of high real interest rates and there is continuing progress on SOE reform which should help underpin the equity market. As China moves to a more market driven economy, the potential for multiple re-ratings of the overall market improves. The authorities in China continue to expand the social safety net which will favour certain sectors such as Healthcare and Insurance for a number of years.

After the strong gains in 2014 and the early part of 2015, the Indian equity market has entered a choppier period as investors wait for corporate earnings to benefit from the improved political environment. Reform in India will continue for a number of years and benign inflation numbers have allowed a further interest rate cut by the Reserve Bank of India. India remains a market likely to reward patient investors over the medium term.

Thailand continues to wait for news on elections from the military government. In the Philippines growth remains strong, with the country benefitting from a competitive service sector and remittances from overseas workers. Indonesia has also lagged the region year to date as investors wait for further evidence of reform by the Jokowi administration.

Japan

The market in Japan has been strong in 2015 although it remains correlated to other developed markets and has fallen with the recent issues surrounding Greece. There are positive signs that the market upturn is now beginning to reflect changes in the broader economy and Japan is finally seeing a sustained improvement in economic activity. Although Japan's equity market was busy outpacing its developed-market peers last year, analysts were lamenting its economy's inability to keep up – as is so often the case, there was a distinct lack of correlation between the two factors.

While there were definite signs of improvement in the UK and US, Japan's economy languished during 2014 but there are some signs of improvement. In June, revised figures for first-quarter Japanese GDP growth were very well received – at 3.9%, the new figure is comfortably ahead of analysts' initial estimate of 2.8%. There are some key factors that are contributing to change, for example Japanese workers' wages increased faster than the cost of living during April. The pickup (the first in two years) was slight, amounting to just 0.1%. In addition the US dollar is strengthening versus the yen - Japan's export-orientated economy is heavily reliant on the purchasing power of international buyers and the strong relationship between a weaker Japanese currency and a rising stock market was evident during May. There has also been a noticeable improvement in Japanese corporate governance. Developments in this sphere were nascent back in February, and have since continued apace. In June, a code which aims to hold companies more accountable to shareholders came into force which bodes well for a more sustained longer term recovery led by structural change.

Emerging Markets

Within Emerging Markets the Asian region has outperformed Russia and Latin America, benefitting from its lower dependence on commodity prices. The decline in the oil price has been a particular drag on both Brazil and Russia where economic growth has slowed sharply from earlier years. Within the emerging world commodity exporters continue to see a deterioration in their terms of trade.

The Latin American region has seen a significant slowdown in growth in its largest economy Brazil, as a result of a combination of poor corporate governance in index heavyweights such as Petrobras, and a lack of political reform which has resulted in the country slipping into recession. President Dilma Rouseff has responded to this by appointing a more orthodox Finance Minister. Brazil remains a country with great long term potential, but has a number of difficulties to overcome in the short term to achieve this. Better management of the economy is necessary to see an uptick in economic growth unless commodity prices rebound rapidly. Other commodity producers in the region, such as Chile and Peru have also seen a slowdown in levels of economic growth.

The Russian economy continues to suffer from Western sanctions put in place following the Ukraine crisis. This has negatively affected most companies in the region with the exception of those with costs in Roubles and revenues in hard currencies such as the US Dollar. Until political tensions in Ukraine ease, a rapid rebound in growth in Russia seems unlikely.

Food price inflation remains benign, which is a positive for most emerging market consumers and an absence of inflationary pressures in the region gives countries that do enact reform programmes scope to cut interest rates.

The current economic environment where commodity prices are weak remains a more difficult one for emerging market economies than was the case five years ago. China's re-balancing away from fixed asset investment to domestic consumption is more of a negative for many Latin American economies than Asian ones. This is a region where strong country and stock selection will be necessary to generate above-average returns, so fund selection remains paramount. Furthermore, there are huge variations in corporate governance in these markets with companies pursuing shareholder friendly policies likely to generate the best returns.

Fixed Interest

Chart showing 2015 returns for major fixed income indices:

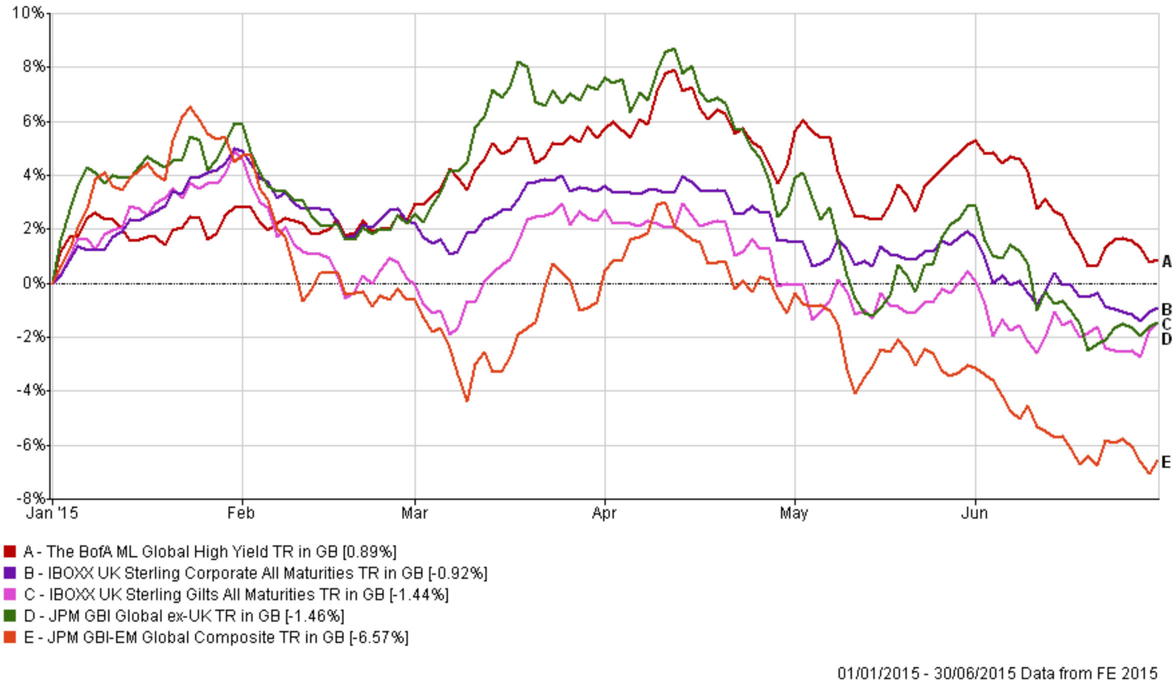
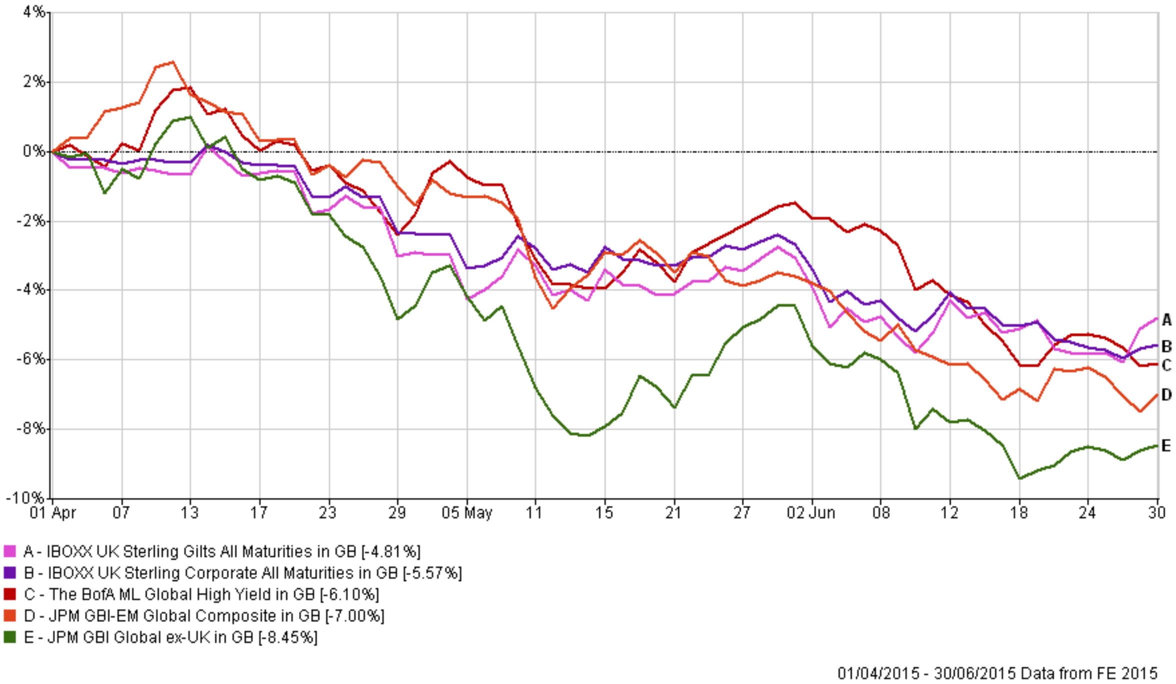


Chart showing quarter two 2015 returns for major fixed income indices:



The second quarter of the year has demonstrated the current uncertainty around the direction of the bond market with greater volatility and rising yields affecting returns. The quarter saw a broad increase in yields led by the increasing likelihood of rises in US interest rates and inflation expectations across the globe. Most central banks have maintained their accommodative monetary stance preferring to err on the side of caution when it comes to protecting the fragile economic recovery we have seen and is predicted. QE has certainly helped this with both Japan and European central banks pumping more liquidity into the global system. This has given markets confidence but has yet to deliver greater levels of bank lending or improve the capital investment made by companies. Much of the rise in company shares in the last few years has been because of the price improvement through re-rating, share buybacks, and cost cutting measures and now earnings need to grow to support prices.

It can be argued that the recent rise in yields only brings them to a more sensible level after a period of unsustainable weakness, and that QE will continue to keep them lower than the natural rate. This effect may take some time to lose its momentum given that many observers feel that interest rate rises, when they occur, will be limited and infrequent.

The key to any real change will be the decision, when it occurs, by the US to raise interest rates. The decision is not an easy one, as data showing improving circumstances in both employment and wage data, as well as growth in structured credit and auto loans, suggests rates need to be raised. At the same time increasing rates too soon could drag the US back into recession as lessons learnt during the great depression still resonate at the Fed. The Fed dots, as they are called, show how each member thinks interest rates will rise in the coming year and this is now more in line with consensus than previously, giving more credence to a rate rise sooner rather than later. Knock on effects of a rise will be a strengthening of the dollar and potentially more demand for dollar debt. Also affected would be emerging markets which have significant debt to GDP ratios - many EM corporates will have dollar rather than local currency debt which could cause some issues when rates rise. It is possible that after a number of countries saw rate rises in early 2015 that a reversal takes place as we move towards 2016. A policy divergence between the west and emerging markets, with the west raising rates and other emerging countries reducing them, may well occur before the end of the year.

The high yield market may offer some positive returns in the second half with spreads showing some potential after recent sell offs. Even corporate bonds may offer better opportunities in comparison to government debt.

In summary there seems little value in government debt with the exception of some selected emerging market countries and we may see diverging interest rate policies as we move further into 2015. Portfolios will need careful balancing but we continue to prefer the longer term view. Rate rises suggest shorter duration holdings should provide some protection but there are opportunities which strategic bond managers should be best placed to exploit. Liquidity remains an issue but there are tools for managers to use including SWAPs, shorter duration assets and higher quality debt to mitigate some of the issues.

Property

Property data still seems to be robust in relation to the rising volatility seen in other sectors. The sector will continue to be influenced by the outlook for interest rates, (expectations for rate rises are generally negative for the sector), the outlook for property and equity markets in general, and investor sentiment, particularly over the short-term. Local market factors typically have a larger influence on this sector than for the equity indices and these should also be taken into consideration. The REIT market is more sensitive to rate rises and it is likely we will see greater volatility in this area as we move closer to interest rate rises.

The UK commercial property market continues to produce good, consistent, positive returns and this is expected to remain the case during 2015. Absolute numbers are likely to be lower than 2014, 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.

Property 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 the first time since 2013 we have seen a negative return from bond markets. Unfortunately we have also seen a similar fall in equity markets with only the US managing to achieve positive returns. The increasing yield environment has been part of an increase in overall volatility in both asset classes and is a reflection of improving data in Europe mixed with political uncertainty in Greece.

The world continues to be under the influence of QE as the European central bank has now added its monetary expansion policy into the mix. Whilst the global economic recovery continues, the rate of improvement remains torturously slow compared to other recoveries. This is demonstrated by the low level of interest rates in safe securities such as core government bonds. Easy monetary policy is likely to be around for some time – even if we do see higher interest rates emerging from the US, it is recognised that the recovery is still fragile and may well be weaker over all given the severity of the crisis that preceded it.

Economists Reinhart & Rogoff in their post crisis analysis 'This Time is Different' highlighted the effect a legacy of private sector debt had on economic recovery. The financial crisis was resolved, but only by transferring some of this debt onto public balance sheets. The economists found that countries with higher debt levels recorded lower growth going forward and this explains why the global economy is in relatively poor shape. This debt burden has been a drag on recovery, with perhaps the only silver lining being the possibility of an extended but muted economic cycle which equity bulls believe could last for perhaps 10 years. It is certainly true that a new recession would hit public balance sheets hard in an era of ageing of Western economies. At the present time the world cannot afford another economic downturn, which perhaps explains the ultra-expansionary policies of Central Banks today.

Looking forward, investors should probably look to sell into significant future market strength rather than add to positions at higher levels. Central Banks on balance are still likely to err on the side of caution and allow the recovery to run on further, and if equities move higher from these levels and through highs of this year by a significant amount ahead of earnings growth, reductions should be contemplated. It is however likely that it will be many years before investors will be able to receive decent returns from cash deposits. The central or base case scenario of a steady but modest increase in growth should be a relatively benign one for equities, with earnings growth the driver of returns not multiple expansion. Returns over the next few years will come in all likelihood with greater, perhaps significantly greater, volatility than investors have grown accustomed to.

We still maintain that a diversified portfolio is the most important defence against changing circumstances and to develop a reasonable natural income in the low interest rate environment we find ourselves today.

Ken Rayner
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