

January 2014



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Three questions for 2014

As we return from the Christmas break, markets are more or less where we left them in December. Investors have a heightened sense of risk appetite, liquidity is free flowing and credit markets are open for business, certainly from a new issues perspective. As is the norm, investors, commentators and market observers are considering the year ahead and predicting how events might turn out. It strikes me that there are three questions we need to consider, and they are in turn interlinked.

Is growth going to become embedded in the developed world? In the US and UK, economic growth appears to be gaining a fair degree of momentum. In the US, the impact of last year's fiscal drag is behind us, growth is building and job creation appears robust. The financial system is working with a strongly-capitalised banking system lending to the real economy. One could argue that with QE still very much evident, one should expect no less, with the US stimulus still running at \$75bn per month. Nonetheless, the US economy looks well placed for 2014 and beyond.

In the UK, growth is also becoming well embedded with the UK economy probably experiencing the strongest growth in Europe in the second half of 2014. Again, private sector job creation is very strong, the leading indicators are all signalling significant expansion, and on the current trajectory, given the strength of the housing market in the South East, one could raise the subject of an interest rate rise this year, something not currently discounted by markets. In Europe, again the leading indicators are all (with the possible and significant exception of France) turning positive. Even Spain appears to be finally emerging from years of austerity. Peripheral bond markets have been on fire so far this year with bond yields falling sharply as tail risks diminish. The key implication of a more robust environment for global growth is that policy measures will continue to normalise, and long and in turn short rates (as I have already mentioned in the case of the UK) will rise. This has a number of implications, not least of all raising the borrowing costs of over-indebted governments and consumers, and providing a challenging headwind for fixed income investors of all types. It is also a scenario in which it is very easy to consider a stronger US dollar.

Will tapering, rising bond yields and a stronger US dollar challenge the emerging markets in the way that it did last summer? It is possible that last year's car crash in EMD and EME was a pre-cursor to a full-blown motorway pile up later this year. In particular the deficit countries more dependent on external financing have remained under pressure from that point onwards. Both the EM equity and debt markets were the standout underperformers last year, although equities had something of a bounce in the second half of 2013. The region's woes have not been helped by the new Chinese government appearing to want to contain the explosive credit formation facilitated by the shadow banking sector which has further undermined investor confidence, as has the prospect of a stronger dollar. Nonetheless, if the region can withstand tighter (or at least less loose) US monetary policy, then real value is beginning to emerge here. Bond yields are significantly higher, and equity PE ratios are much lower than in the developed world. At some stage the region will become attractive. For now, we would like to see some evidence of stability before considering an increase in exposure.

The final question surrounds the prospects for corporate profits. Equity markets have clearly performed extraordinarily well over the last couple of years; the S&P 500 is up by 50%, the FTSE All-Share by more than 33% and the MSCI World index by over 40%. Although corporate profits have grown, this growth has been nowhere near as strong as equity markets have been, and so the return from equities has been driven by a rerating fuelled by increasing confidence and ongoing central bank stimulus and liquidity provision. For equity markets to make further progress we really need to see corporate profits growth take up the running. It is unlikely that stock markets can make much progress without that happening. But if we return to our first question, and work on the basis that global growth takes hold, there is every reason to believe that this will provide the perfect backdrop for corporate profits growth,

although we will need to be mindful of falling unemployment's impact on margins given their elevated levels.

So for now we are paying very close attention to these three issues: the growth outlook, what a normalised yield curve means for emerging markets, and whether global economic growth can be translated into corporate profits growth. There is one final issue to consider. We are now nearly six years away from the global financial crisis although it is very much closer in most investors' memories. Looking at past cycles, history would suggest that we are closer to the start of the next crisis than the previous one. Let's hope that proves not to be the case!

Asset Allocation Matrix: End December 2013

	Strongly dislike	Dislike	Neutral	Favour	Strongly favour
Asset Allocation	Govt	I/L	Cash Commodities	Credit Equity Property	
Equity Region		US	Europe ex UK Pacific ex Japan Emerging Markets	UK Japan	
Global Equity Sector		Energy Utilities Telecoms	Materials Industrials Healthcare Staples Financials		Technology Consumer Cyclicals
Bonds – FX Hedged		Japan	Germany US UK	Nordics Australia EM Local	
Credit			Corporate IG EMD	Corporate HY	
Commodities		Base Metals Softs	Grains Livestock Precious Metals		Energy
FX		JPY AUD Euro	Nordics	GBP	USD
Portfolio Risk			X		

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