Wealth
Management

December 2013

# Quarterly Strategy


Economic conditions improved considerably in the quarter, and the Federal Reserve started to plan for the tapering of its asset purchases, which it announced will begin in January. Despite scaling back on its bond purchases, we believe it is unlikely to raise interest rates before 2015.

This continued accommodative stance is enabling markets to focus attention on the brighter economic outlook, which is also taking shape in the UK and Europe.

In this document, we discuss the economic and market environments, and how our views are being reflected in our customers' portfolios.

C. Hoare & Co.
PRIVATE BANKERS SINCE 1672

## Our outlook for 2014 and current strategy

We believe equities will continue to outperform bonds in 2014, but the path is rarely straightforward and we will be alert to any potential stumbling blocks along the way. We remain upbeat on the global economic outlook, the opportunity for companies to become more expansive in their hiring and capital expenditure plans, and investors continuing to return to the equity market. In contrast, we expect to see bond prices fall marginally.

## Economic and political news

The global economy delivered positive news in the quarter, with growth recovering in many regions. After the tribulations of the last few years, progress has certainly been welcome, and anxiety has only been modest surrounding the Federal Reserve's decision to scale back, or taper, its asset purchasing programme.

The end of Quantitative Easing (QE) was always going to be reliant on economic conditions, and manufacturing, consumer confidence and employment have all been improving in the US. The government shut down in October has had a limited effect. It appears to have sobered the mood in Washington, with the latest budget deal likely to solve the impasse for the next two years. With the outlook brightening, the Federal Reserve announced the beginning of tapering, but emphasised that interest rates will not rise until 'well past' the unemployment rate falling below 6.5%.

The UK has also seen notable improvement, largely because of the stabilisation of the banking system. Loan issuance has picked up and the price of borrowing has fallen. This in turn has allowed a rise in housing demand and construction output, which we expect to continue in 2014. Government spending is likely to remain constrained in order to meet medium-term debt targets.

A moderate recovery has begun to take place in Europe, with the worst of the austerity measures now passed. Manufacturing and net trade is picking up, including in peripheral countries, although France remains a concern as it lags on reforms. The Asset Quality Review of banks may crimp credit provision in 2014, but will enhance credibility of the banking sector to investors. The European Central Bank remains aware of the ongoing risks of deflation, due to austerity and poor credit growth, but providing additional funding is more likely than direct asset purchases.

This year's regime change in Japan has seen an ambitious plan to escape deflation via an aggressive expansion of the money supply. The first effect was a weakening of the yen, which has improved exporters' profits. The next reforms will include an increase in consumption tax in April, which may depress demand temporarily. Policy aims to increase wages via tax breaks, which would be positive for domestic consumption and profit margins.

Emerging markets have struggled this year with a worsening of the price and availability of dollar finance, and internal growth disappointments. The best route back to high growth is structural reforms to boost productivity. China has introduced an ambitious reform programme to improve market price discipline, but will need to overcome vested interests. This lower trend growth environment could throw up further pitfalls in 2014.

The following table shows our current position in each of the major asset classes and regions, as well as an indication of what our next portfolio change might be.

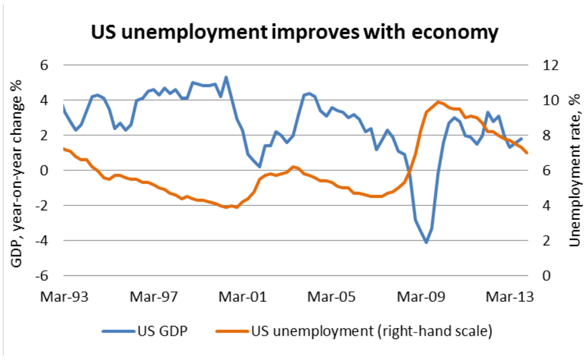
| Asset class | Current Position | Expected next move |
|---|---|---|
| **Equities** | + + | |
| UK | - | |
| US | neutral | ▼ |
| Europe | ++ | |
| Japan | ++ | |
| Asia Pacific | neutral | |
| Emerging Markets | + | ▼ |
| **Bonds** | - - | |
| Government | - - | |
| Corporate | + | |
| **Alternatives** | - | ▲ |
| **Property** | - | |

Key to symbols used in above table:

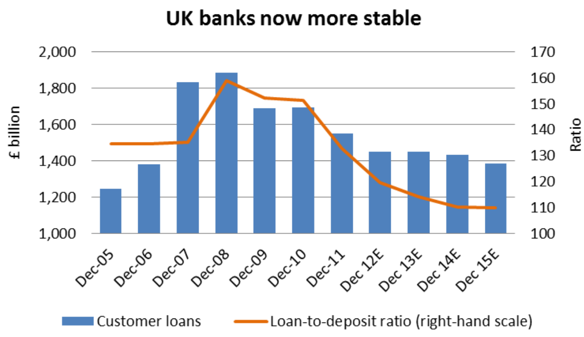
| | | | |
|---|---|---|---|
| + | 1-3% overweight | - | 1-3% underweight |
| ++ | >3% overweight | - - | >3% underweight |

▲ We expect to increase our position

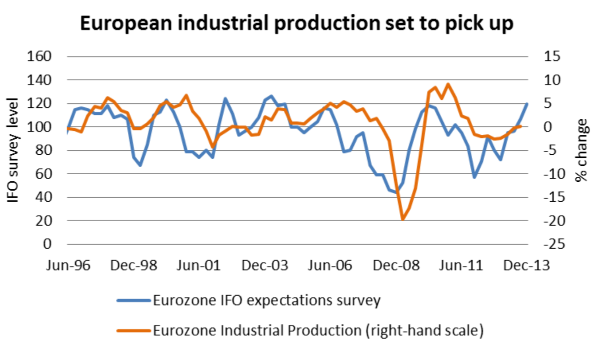
▼ We expect to reduce our position




*Source: Bloomberg, as at 30th November 2013*



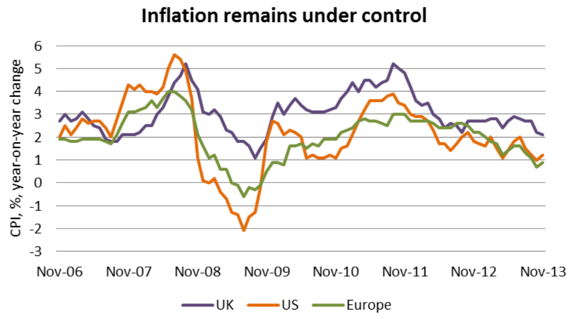

*Source: Deutsche Bank, based on combination of Barclays, Lloyds and RBS, as at 30th November 2013*




*Source: Bloomberg, as at 30th November 2013*

## Currencies and interest rates

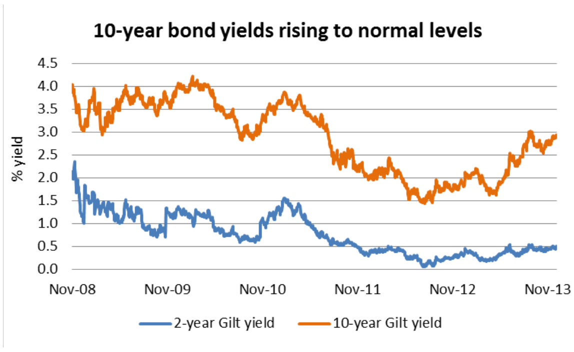
Inflation has trended lower over the last year, due to weaker commodity prices, and ongoing spare capacity in the global economy. This has allowed central banks to maintain low interest rates, and indications are that they will remain low through 2014, even as employment improves in the US and UK. As a result, we expect the first rate rises to occur from mid-2015 onwards in the UK and US, and from early-2016 in the Eurozone. Inflows to riskier assets in Europe have benefited the euro and sterling, but we expect tapering to allow the dollar to recoup declines in 2014.




*Source: Bloomberg, as at 30th November 2013*

## Bond markets

Government bond markets were particularly expensive at the start of 2013, with yields generally less than 2%. This was driven by investors' excessive caution and central banks' bond purchases. Yields of shorter dated bonds remain well anchored by accommodative monetary policy, but bonds further out along the curve are beginning to price in a return to more normal interest rate levels. We expect modest upward pressure on yields in 2014, towards 3.25—3.5%, but a good part of this has already taken place, which is shown in the chart on the right.




*Source: Bloomberg, as at 19th December 2013*

The difference between corporate bond yields and government bond yields (i.e. the credit spread) narrowed in 2013 to more normal levels. We expect the spread to remain fairly stable, meaning corporate bonds should provide a modest yield premium.

| | Earnings growth | | Price/Earnings | |
|---|---|---|---|---|
| | 2013 | 2014 | 2013 | 2014 |
| UK | -4.0% | 12.1% | 14.4 | 12.8 |
| US | 5.7% | 10.5% | 16.4 | 14.9 |
| Europe ex UK | -2.6% | 16.2% | 15.7 | 13.5 |
| Japan | 67.2% | 9.7% | 15.4 | 14.0 |
| Asia ex Japan | 10.6% | 13.1% | 12.7 | 11.2 |
| Latin America | 6.1% | 15.6% | 14.5 | 12.5 |
| Eastern Europe | -4.3% | -0.7% | 6.5 | 6.6 |
| World | 6.1% | 10.9% | 16.1 | 14.5 |
| | | | | |
| Cons discretionary | 19.6% | 11.4% | 17.3 | 15.5 |
| Cons staples | 5.5% | 9.6% | 19.2 | 17.5 |
| Energy | -5.8% | 10.4% | 12.5 | 11.3 |
| Financials | 11.8% | 10.5% | 13.3 | 12.0 |
| Healthcare | 0.5% | 8.2% | 17.7 | 16.4 |
| Industrials | 7.2% | 14.2% | 17.3 | 15.1 |
| IT | 9.3% | 12.2% | 15.8 | 14.1 |
| Materials | -6.5% | 17.4% | 16.3 | 13.8 |
| Telecoms | -2.7% | 7.5% | 15.5 | 14.4 |
| Utilities | 23.4% | 6.5% | 15.0 | 14.1 |

*Source: Deutsche Bank, as at 19th December 2013. Figures based on estimated earnings for 2013 and 2014.*

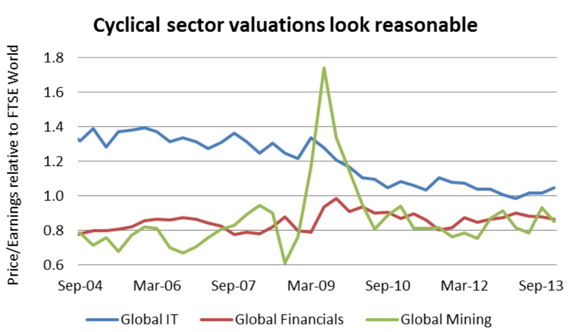
## Equity markets

Despite economic improvement, corporate profit growth has remained lacklustre in 2013. Global conditions and, in some cases, domestic factors impacted company fortunes. With the US economy strengthening, for instance, US consumer and financial firms did well. The technology and industrial sectors, however, were held back by weak corporate investment and global conditions. The UK was impacted by falling returns in basic resources. European profits have been held back by low domestic demand. Japan saw very strong profit growth on the back of yen weakness, and Asia suffered due to difficulties at home.

We view equities as fairly valued, but expectations for earnings growth are now higher for 2014, at 10-15% worldwide. In broad terms, we are confident that earnings growth will be strong enough to surprise positively over the next 12 months, but we are wary that individual markets, industries or companies may disappoint. As such, we favour those areas that could benefit from a broad-based cyclical recovery and have reasonable valuations, which at a sector level includes technology, financials and basic resources.

## Alternative Investments

Performance of Real Estate Investment Trusts has been impacted by tapering in the US, with the attraction of property income streams reduced by higher bond yields. Over the longer term, however, the better environment should be positive for rent increases and capital values, which we expect to translate into better returns in 2014. Commodities remain under pressure due to over supply in areas such as oil and gas. We continue to favour equity-oriented alternative strategies, as we see this area as offering the best opportunity set for active fund managers.




*Source: Bloomberg, as at 19th December 2013*

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**Important Information**



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