Wealth
Management

April 2013

# Quarterly Strategy

After years of worrying about one crisis after another, investors now seem to believe in a moderate recovery, albeit one that could take some time.

This transitory period is marked by a shift from low-yielding Gilts into equities and other risk assets. It should also herald further outperformance of equities, but we remain wary of uncertainties that could hamper this recovery.

Within our customers' portfolios we are retaining overweight positions in equities and underweights in bonds. We have also invested in a property fund for customers for whom exposure to the asset class is suitable.

C. Hoare & Co.
PRIVATE BANKERS SINCE 1672

## Our current investment strategy

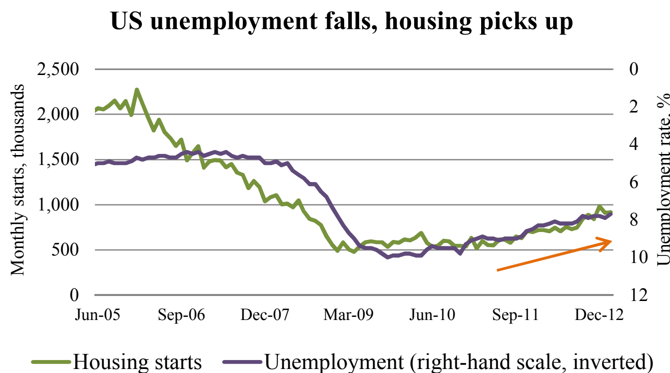
While economic conditions overall remain difficult, we do not expect the global economy to slip back towards recession. We are realistically optimistic, continuing to hold overweight positions in equities and underweights in bonds.

In the previous quarter's report, we alluded to the increasing attractiveness of the property market, particularly with Gilt yields likely to remain at very low levels for the foreseeable future. We have been out of the asset class since late 2008, but have now introduced a global property fund to those of our customers' portfolios for which it is suitable.

| Asset class | Region or sub-class | Our current position | Our expected next move |
|---|---|---|---|
| **Equities** | | ++ | |
| | UK | + | |
| | US | – | |
| | Europe | + | |
| | Japan | neutral | |
| | Asia Pacific & GEM | ++ | |
| **Bonds** | | – | |
| | Government bonds | – – | |
| | Corporate bonds | + | |
| **Alternatives** | | + | ↑ |
| **Property** | | **neutral** | |

## The economic and market environments

Markets are undergoing a transition from being dominated by the crises of the last five years to one in which we are expecting moderate recovery in the years ahead. There have been considerable improvements within the global banking system and both the US housing and employment markets, as shown in the following chart. Further indications of a self-sustaining recovery in the US can be seen in improving manufacturing surveys and credit creation.

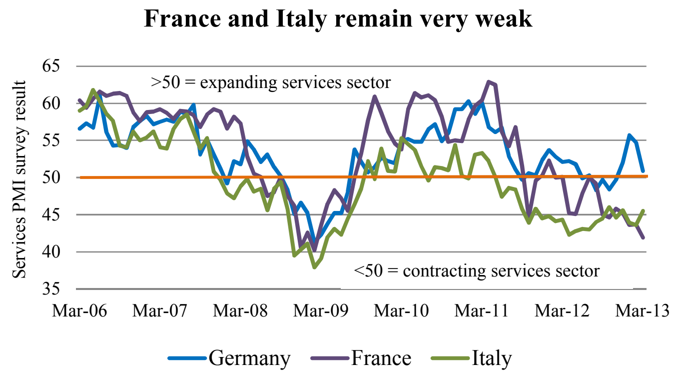



Source: Bloomberg, to 28th February 2013

The year-end tax increases and government spending cuts in the US are moderating growth in the short term, while politicians are now focussing their efforts on longer-term budget reforms. We expect the Federal Reserve to maintain loose monetary policy in the months ahead, even if confidence in the recovery returns sooner than anticipated.

There is no doubt, however, that this cycle is proving complex, with a globalisation, financial and fiscal crisis combining to give a very long recovery period.

The outlook for the Eurozone remains mixed at best. We are encouraged by Germany becoming less reliant on the rest of the world and having good prospects for domestic spending. France, on the other hand, is finding the early stages of implementing austerity and reform negative for growth, while Italy is now vulnerable to a weak government. These concerns could lead to further declines in confidence.



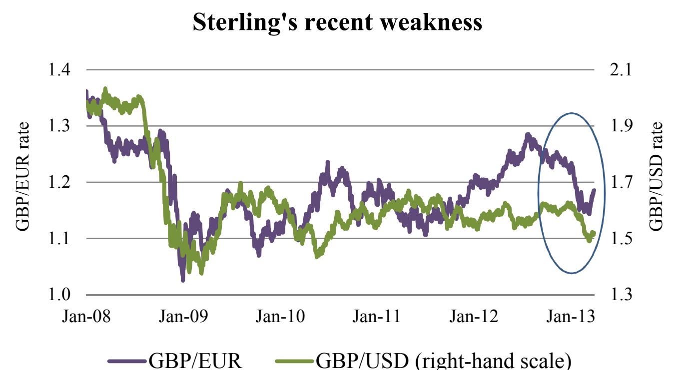

Source: Bloomberg, to 31st March 2013

In the UK, we have seen little improvement in short-term growth prospects, and this has led to further negative revisions to government debt ratios and the first credit rating downgrade. The UK's open trading economy should benefit from a broader global recovery, but fiscal concerns will linger for some years. Monetary policy is likely to remain loose, given the Bank of England's increased tolerance for a longer period of inflation as it looks to support the economy.

Inflation is also a concern in key emerging markets such as China and Brazil, which remain vulnerable to their own internal dynamics as well as global recovery prospects.

## Sterling has weakened

The environment depicted above has led to a weakening in the value of sterling, versus both the dollar and the euro, and we expect this dynamic to continue. Although the euro benefits from the European Central Bank's firmer inflation target, we expect systematic risk to remain due to elevated debt levels in some countries. As global investors, we are mindful of the opportunities and risks that a more volatile currency environment creates.

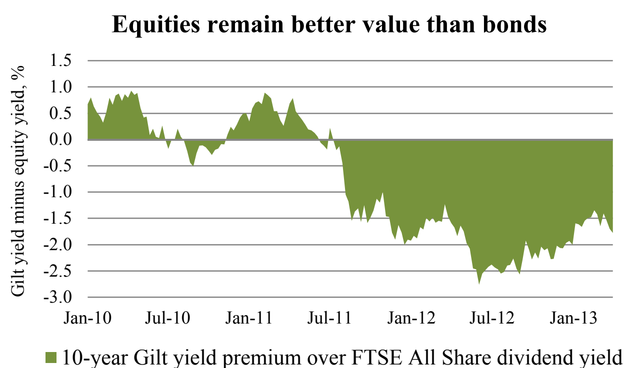



Source: Bloomberg, to 29th March 2013

## Bonds offer little value

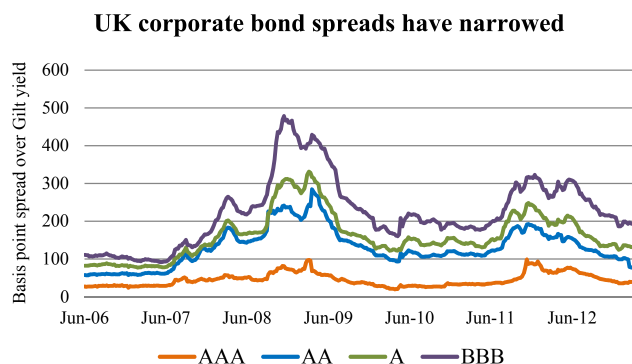
Government bonds remain poor value, but low yields are an outcome of the loose monetary policy and quantitative easing. There is nervousness in the US over whether this situation will change, but policy looks well entrenched in the UK, the Eurozone and Japan. The proactive nature of some central banks may make inflation expectations more unpredictable, increasing risk premiums accordingly.

In recent months, it has been increasingly clear that equities represent better value than Gilts and other so-called safe havens. Equity prices have risen in response, which has reduced the gap in terms of the yield on dividends versus the yield on Gilts, as shown in the following chart. Gilt yields are generally higher than those of equities.




Source: Bloomberg, to 29th March 2013

While the Gilts market has been fairly flat over the past year, corporate bonds have performed well with credit spreads continuing to narrow in recent months. Yields on higher quality issues have returned to close to their pre-crisis levels. Default rates have remained low, but as this is now reflected in bond prices, there is less potential for credit to perform strongly.

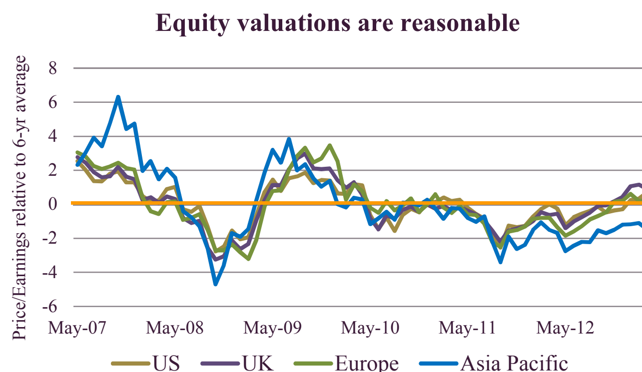



Sources: JP Morgan, Bloomberg, to 29th March 2013

## We remain positive on equities

The last quarter has been quiet for changes to corporate profit forecasts, with only Japan showing signs of upward momentum. This year, we expect sales to pick up but margins to remain fairly flat, and overall earnings growth to be 10-11% worldwide. These forecasts could rise if companies become more optimistic and increase activity.

As a result, current valuations as measured by equity prices divided by their expected earnings over the next 12 months (Price/Earnings or P/E ratio) look reasonable. This is particularly true in the Asia Pacific region, as shown in the following chart, with P/E ratios significantly lower than their average of the last six years. If, however, we see a general improvement in earnings expectations, which we believe is quite possible, valuations in other regions will also look increasingly cheap.




Source: Bloomberg, to 31st March 2013

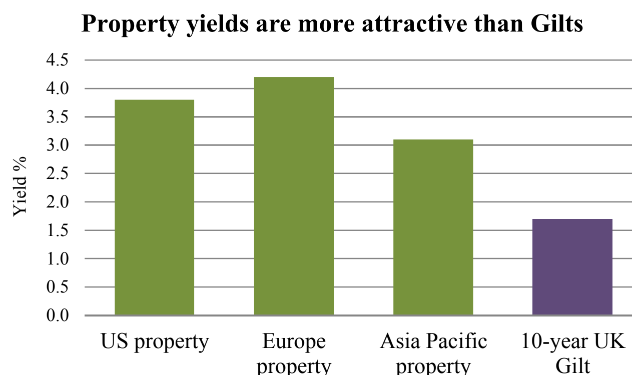
There has been some talk in the market about a 'great rotation' from the safety of cash and government bonds into equities, but fund flows indicate only modest shifts in the year to date. We expect investors to continue raising their exposure to equities in 2013, which would provide reasonable support for the asset class.

## Sectors and themes

We remain positive on the US financial sector, due to improving balance sheets and their direct exposure to the US domestic economy. The technology sector, by contrast, is more global, but we believe industry winners continue to have strong growth prospects.

## Staking a claim on property

Gold remains useful for protection against systemic risks, and we are increasingly positive on property for diversification, the inflation-linking elements of rental payments and the opportunity to benefit from elevated risk premiums and bank deleveraging.




Source: Henderson Global, to 31st January 2013

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