Quarterly Strategy

Investors are enjoying a much brighter outlook now that the clouds that darkened the economic sky over the past few years appear to have finally dissipated. (An unusually hot British summer is also adding to the more upbeat mood!)

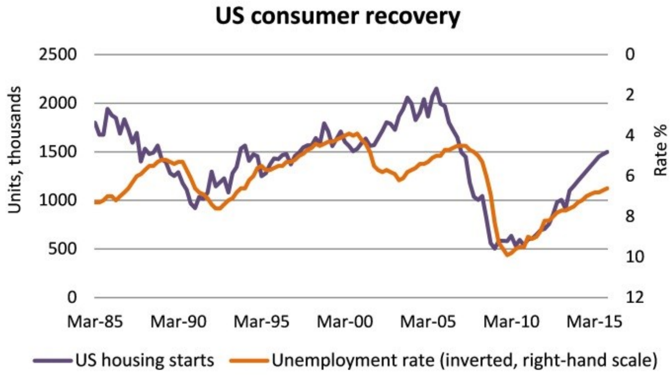
As the Federal Reserve prepares to slow down on the asset purchases that have so far provided such a big lift to markets, we now have to consider whether the global economy, and stock markets, can indeed fly unaided.

We believe government bond markets will struggle without the tailwind from the US central bank, but equities overall should be in better shape.

C. Hoare & Co.
PRIVATE BANKERS SINCE 1672

Economic and political news

The US economy continued showing signs of sustained growth in the second quarter. For example, new house building and home sales are on the increase, while the numbers of hours worked and of new jobs being created have also risen. These trends have helped boost consumer sentiment, which in turn has helped support the economy.

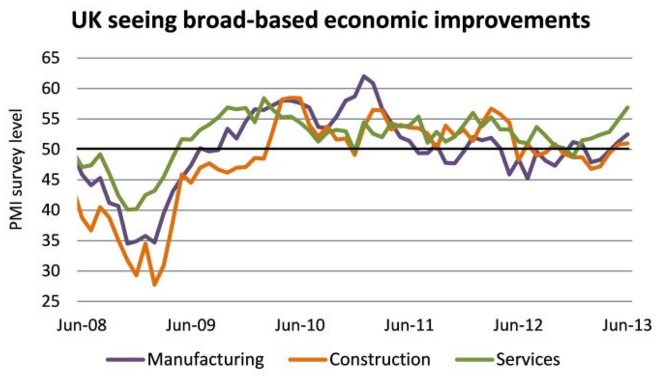


Sources: Bloomberg and, for forecasts, Goldman Sachs and Consensus Economics, to 30th June 2013

While these developments are clearly positive, Federal Reserve chairman Ben Bernanke took the opportunity to announce the Fed's readiness to slow the pace of quantitative easing if the US economy continued to improve.

In contrast, the Bank of Japan has just embarked on its own aggressive programme of asset purchases, which has helped to weaken the yen, making exports more competitive. This, combined with fiscal stimulus measures, has led to increases in profit and GDP forecasts. We expect to see increased consumer spending in Japan and possibly structural reform.

Economic news has also been broadly positive in the UK, with improvements in the services and housing sectors contributing to rising growth forecasts.



Source: Bloomberg, to 30th June 2013

When the Bank of England's Monetary Policy Committee meets in August, it may announce guidance on the path of interest rates, possibly based on UK unemployment targets being met.

Europe is proceeding slowly but unevenly, with economic growth expected to return in 2014, We believe the main risk now is disappointment in structural reform programmes, which could lead to a reappraisal of debt sustainability, in Italy or France.

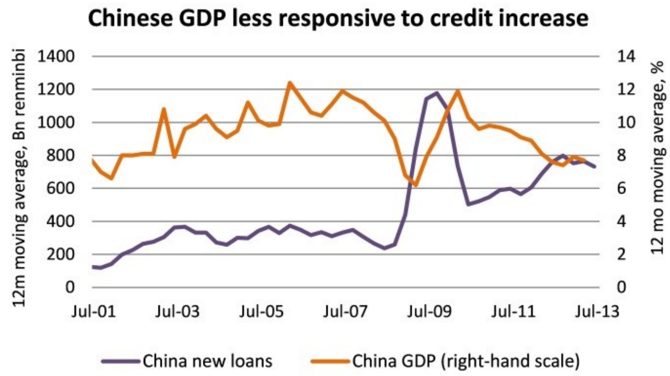
The impact of the US announcement

Bernanke's announcement has marked an inflection point in the provision of liquidity globally. The Federal Reserve's $85 billion of monthly asset purchases has been the driving force behind strong financial market performance, and the realisation that the stimulus could soon be curtailed triggered a global sell-off in May. Some equity markets have since recovered, but bond prices have remained under pressure.

The impact has been felt in the US but has been more severe in other parts of the world, most notably in countries where economic recovery is less established.

On the whole, Asia and emerging markets have performed poorly, due to growing concerns about the impact of lower liquidity on countries with current account deficits. This has combined with growth downgrades and structural concerns over India's inflation and underinvestment, Brazil's competitiveness and Russia's transparency.

Concerns over Chinese credit and overinvestment have been illustrated by recent spikes in interbank rates. We continue to monitor for any financial stress.



Source: Bloomberg, to 25th June 2013

Currencies and interest rates

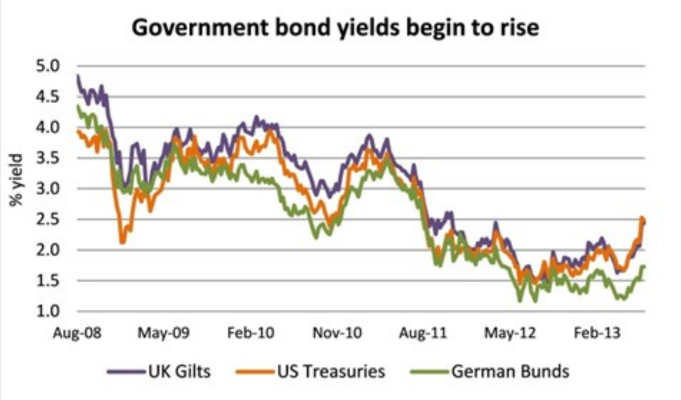
While asset purchases are expected to be tapered later this year, we feel that an increase in US interest rates is unlikely before 2015, by which time unemployment should have improved from 7.6% currently to around 6.5%. Without immediate rate catalysts, the US dollar, the pound and the euro have not diverged widely, but we expect the dollar to reflect the better economic outlook of the US in due course, in particular against the yen, given Japan's loosening of policy.

The inflection point for monetary policy is demonstrating elevated valuations in some of the more defensive currencies such as the Australian dollar, the Swiss franc and the Norwegian krona. Foreign exchange markets are also particularly wary of emerging markets with significant current account deficits, such as India, Turkey and Brazil.

Bond markets

As we flagged in recent reports, government bond markets have now started to lose some of their safe haven attractiveness. From here, we expect bonds to react more closely to economic news, and yields to rise accordingly, in line with growth forecasts.

In the longer term, bond yields may not rise all the way back to pre-financial-crisis levels, as potential growth is likely to be lower. The current growth environment remains favourable for credit, and default rates remain low. Corporate bond yields relative to those of safe haven government bonds (i.e. 'the spread') no longer offer the attractive buying opportunities that we saw in previous quarters, and are now fair value.



Source: Bloomberg, 10 year bonds, to 28th June 2013

Equity markets

Analyst forecasts for corporate earnings have been mixed, with Japan seeing upgrades due to a weaker yen, the US flat and Europe with continuing downgrades, particularly in peripheral countries. In developed markets, equity valuations have returned close to the levels they were trading at the beginning of the year. In an environment of improving economic activity and rising bond yields, equities in these developed markets remain good value absolutely and relative to bonds.

	Growth		Price/Earnings	
	2013	2014	2013	2014
UK	3.2%	10.6%	11.7	10.6
US	7.0%	11.1%	14.5	13.0
Europe	3.3%	14.7%	12.2	10.7
Japan	60.4%	10.3%	13.9	12.6
Asia ex Japan	15.8%	12.8%	10.8	9.6
Latin America	17.7%	12.1%	11.3	10.1
Eastern Europe	-6.3%	2.9%	5.7	5.5
World	8.5%	11.2%	13.0	11.7

Sources: Bloomberg and Deutsche Bank, to 28th June 2013

The regions most impacted this quarter have been Asia and emerging markets. Earnings forecasts have fallen, but these markets have seen their valuations decline as a result of heightened risk concerns. If prospects do improve slightly, equities are likely to rise from here.

The financials and consumer discretionary sectors have continued to receive earnings upgrades from analysts, with most other sectors, particularly basic materials, being downgraded.

We continue to favour US financials, as balance sheets improve and earnings normalise, and technology companies, which offer structural growth, exposure to rising corporate spending and attractive valuations.

On a broader basis, some of the defensive sectors such as consumer goods and utilities have performed well as their earnings and dividend streams have been perceived as low risk and offering a good alternative for those seeking higher yields. With bond yields now rising, however, we expect them to lag and the more cyclical sectors to outperform in the months ahead.

Alternatives

Property has become more attractive, as economic recovery should bolster rents and the asset class, overall, is still fairly valued. We favour equity-based alternative investment strategies, specifically those standing to benefit from further divergence in corporate prospects, but expect the choppy environment to remain difficult for global macro strategies. We also think the inflection point in monetary policy has reduced the need for the protection gold traditionally offers.

Outlook

We believe Bernanke chose a wise moment to announce to markets that US policy will eventually tighten, because the major developed economies can now resume a path closer to potential growth. There are concerns still in the market, some of which have been highlighted here already, but we expect these to be addressed in the coming months. Meanwhile, we remain alert to any hidden dangers that may surface as a result of the sheer extent of balance sheet expansion.

This leads us to continue favouring equities over bonds, given eventual profit upgrades and relative valuations. We have continued reducing the sensitivity of our portfolios to a rising interest rate environment, and entered the third quarter with an above-normal level of cash. We will use part of this cash to increase our allocation to Japanese equities and will continue looking for compelling opportunities elsewhere.

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		–	

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Important Information

Image credit: http://www.123rf.com/photo 7791531 paraglider with blue sky and clouds

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