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VIEWPOINT

Newsflash

A new month and the 69th issue of Viewpoint from PPi.

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The sharp selloff in markets in May continued into the early days of June, with the market's attention firmly focussed on the debt problems in the Eurozone and growing evidence of a slowdown in the key economies of the US and China.

Spain finally succumbed to an inevitable bailout request at the start of the month, asking the Eurozone for EUR 100 billion of funding to support its ailing banking system. While the acceptance of the need for help and the Eurozone's agreement to assist initially calmed markets, investors took fright when the terms of the support left many questions unanswered. In particular, it appeared that the bailout funds would be lent to the Spanish government and not directly to banks, thereby adding to the burgeoning public debt burden, and that existing bond holders would be subordinated. Spanish bond yields duly rose to over 7%, considered to be an unsustainable level.

Sentiment began to improve, however, ahead of the Greek elections on 17 June, as fears over a socialist party (Syriza) victory began to recede. The socialists campaigned on a platform of rejecting the terms of Greece's bailout from fellow Eurozone members, raising the real risk of a disorderly exit from the euro and a full debt default. A gradual shift in opinion polls and heavy Greek support for staying as part of the single currency began to improve investor sentiment. This was then justified with the centre right party winning enough electoral support to be able to form a coalition government and thereby avoid the immediate risk of disorderly exit and default.

Equity markets began to recover some poise, while still remaining very uncertain, especially over the unfolding events in Europe and notably Spain. Government bond yields in peripheral Europe began to stabilise and investors returned cautiously to equities. Noises from key central banks in Europe and the US also suggested that the authorities were ready to resort to further monetary easing, in a bid to add liquidity to the system.

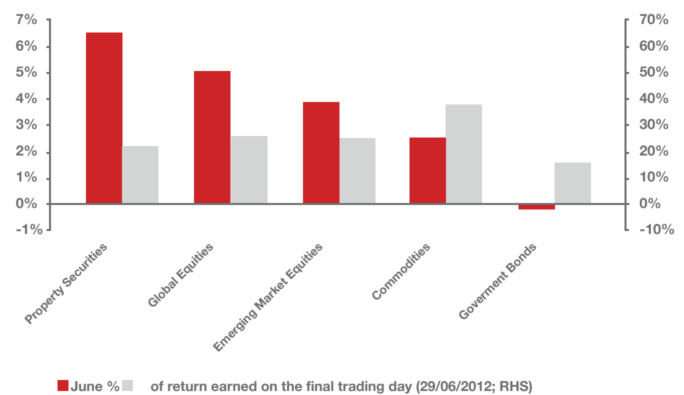
With European leaders meeting at the end of June for the 19th summit since the Eurozone debt crisis erupted, investors held out little hope of any substantive progress towards the type of structural reforms required to engineer a sustainable long term solution to the region's problems. In the event, Germany offered a surprise, by agreeing to some modest growth initiatives and much more importantly to direct bailouts of Eurozone banks from European funds in return for more centralised supervision of the sector. Agreement was also reached that loans to indebted Eurozone countries from central coffers would not be senior to existing debt, thereby maintaining the status of all bond holders.

The result was an immediate rally in equity markets as sentiment improved dramatically amid hopes that Europe was gradually moving towards greater integration and an enhanced fiscal union. The MSCI World index rose by 3% in a single day, its biggest move of the year, and many European markets rose by over 5%. Yields on peripheral European debt markets fell sharply. The net result was that the MSCI World index gained 5.1% over the month, with Japan leading the way with a 7.2% rise. Safe haven government bonds including US treasuries, UK gilts and German bunds alternatively lost ground. Despite this performance from the rates market, spread compression helped investment grade and high yield fixed income to gains, whilst emerging markets bonds were also the beneficiaries of investor flows.

Commodity markets did not participate fully in the recovery as investors remained concerned that the apparent slowdown in global growth, especially in the Chinese economy which has been the biggest buyer of commodities in recent years, would spell an end to the commodities super cycle. Despite a recovery at the end of the month the oil price was still down by 11.5% in June, taking its cumulative fall to over 30% since the peak earlier this year, while industrial commodities were flat. Gold rallied but by less than equities, with a rise of 2.6%.

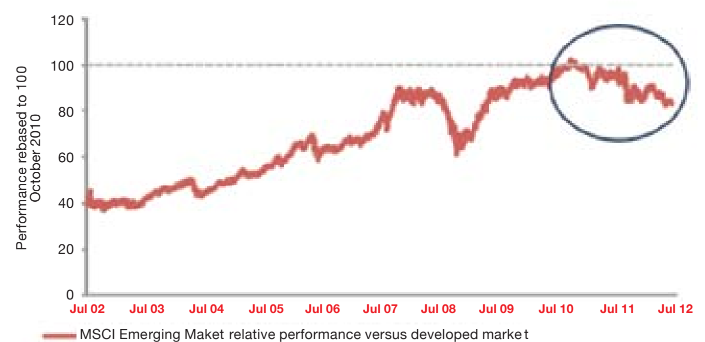
Figure 1 summarises the returns of major asset classes last month, and the proportion of gains that were earned during this final day's trading.

Figure 1: Total returns by asset class (US dollar terms)



Stocks in emerging markets (EM) underperformed their developed counterparts in June, with the MSCI EM aggregate rallying by 3.9% in US dollar terms. This underperformance is consistent with the trend established since October 2010. Figure 2 highlights the relative performance of EM equities over the past 10 years, rebased to 100 at the end of October 2010.

Figure 2: EM underperformance since October 2010



Source: Momentum Global Investment Management / Bloomberg/ Lipper Hindsight. June 2012

The result of these price movements is that EM now appears cheap on a number of fundamental valuation measures, including price-to-book and price-to-sales, relative to the preceding five years of data.

The markets are now at an interesting juncture. On the one hand the Eurozone crisis has eased a little, and there are steps underway towards closer Eurozone integration in monetary and fiscal matters. Whilst we are still clearly a long way off a full fiscal union and issuance of Eurozone backed bonds, at least some of these issues are now on the agenda. There is a long way to go before the debt crisis in Europe is resolved but the euro endures and there has been no disorderly exit or default. Monetary policy remains extremely loose, with the European Central Bank cutting rates by 0.25% post the end of the quarter, whilst the Bank of England has embarked on another round of quantitative easing and the Federal Reserve has extended Operation Twist and will provide more support as and when needed. The fall in commodity prices, especially oil, will see inflation falling and will provide a welcome bonus to consumers.

Yet on the other hand economies have slowed and there is little to suggest that they will bounce back to higher growth levels in the near future. China is slowing structurally, and moving to a less commodity intensive economy, large parts of Europe are in recession and will remain so as fiscal austerity bites and the US faces its own fiscal consolidation post November's Presidential election. Companies remain cautious in this environment and recent earnings announcements have reflected much slower growth, whilst the debt overhang globally will keep risks high and spending subdued for many years to come.

These competing forces are likely to result in continuing volatility in markets in the months ahead, with periods of decent growth punctured by periodic setbacks. Underpinning equity markets, however, are pockets of value. Historically, starting valuations have been a powerful determinant of future equity returns, and, whilst wary of the macroeconomic environment, today's stock market levels warrant a closer inspection by investors.

Source: Momentum Global Investment Management / Bloomberg/ Lipper Hindsight. June 2012

Asset Class Performances

Asset Class/Region	Index	To 29 June 2012		
		Currency	Month	Year to date
Developed Markets Equities				
United States	S&P 500 NR	USD	4.1%	9.1%
United Kingdom	FTSE All Share TR	GBP	4.8%	3.3%
Continental Europe	MSCI Europe ex UK NR	EUR	5.6%	4.2%
Japan	Topix TR	JPY	7.2%	7.0%
Asia Pacific (ex Japan)	MSCI AC Asia Pacific (ex Japan) TR	USD	6.3%	5.9%
Global	MSCI World NR	USD	5.1%	5.9%
Emerging Market Equities				
Emerging Europe	MSCI EM Europe NR	USD	11.9%	6.6%
Emerging Asia	MSCI EM Asia NR	USD	2.5%	5.0%
Emerging Latin America	MSCI EM Latin America NR	USD	3.9%	-0.5%
BRICs	MSCI BRIC NR	USD	3.5%	0.4%
Global Emerging Market	MSCI EM (Emerging Markets) NR	USD	3.9%	3.9%
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	-0.4%	1.7%
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	-0.6%	4.2%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	0.4%	4.7%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	2.1%	7.2%
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	-1.0%	1.8%
UK Corporate (Investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	GBP	0.3%	5.0%
Euro Government Bonds	Citigroup EMU GBI TR	EUR	-0.7%	3.7%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	-0.2%	5.7%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	EUR	1.9%	11.6%
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	-0.1%	1.4%
Australian Government	JP Morgan Australia GBI TR	AUD	-0.6%	5.3%
Global Government Bonds	JP Morgan Global GBI	USD	-0.2%	0.4%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	0.4%	1.3%
Global Convertible Bonds	UBS Global Convertible Bond	USD	2.4%	5.0%
Emerging Market Bonds	JP Morgan EMBI +	USD	3.8%	6.9%

Source: Momentum Global Investment Management / Lipper Hindsight. June 2012

Asset Class/Region	Index	Currency	To 29 June 2012	
			Month	Year to date
Property				
US Property Securities	MSCI US REIT TR	**USD**	5.5%	14.3%
UK Property Securities	FTSE EPRA/NAREIT United Kingdom TR	**GBP**	4.9%	14.2%
Europe ex UK Property Securities	FTSE EPRA/NAREIT Developed Europe ex UK TR	**EUR**	3.9%	10.7%
Australian Property Securities	FTSE EPRA/NAREIT Australia TR	**AUD**	4.2%	16.6%
Asia Property Securities	FTSE EPRA/NAREIT Developed Asia TR	**USD**	8.4%	18.2%
Global Property Securities	FTSE EPRA/NAREIT Developed TR	**USD**	6.5%	15.3%
Currencies				
Euro		**USD**	2.6%	-2.2%
UK Pound Sterling		**USD**	1.9%	0.9%
Japanese Yen		**USD**	-1.7%	-3.6%
Australian Dollar		**USD**	5.7%	0.0%
South African Rand		**USD**	4.7%	-1.3%
Commodities				
Commodities	RICI TR	**USD**	2.5%	-5.2%
Agricultural Commodities	RICI Agriculture TR	**USD**	8.7%	-0.2%
Oil	ICE Crude Oil CR	**USD**	-11.5%	-14.0%
Gold	Gold index	**USD**	2.6%	4.4%
Hedge Funds	HFRX Global Hedge Fund	**USD**	-0.3%	1.2%
Interest Rates			**Current rate**	**Change at meeting**
United States	20 June 2012	**USD**	0.25%	-
United Kingdom	5 July 2012	**GBP**	0.50%	-
Eurozone	5 July 2012	**EUR**	0.75%	-0.25%
Japan	14 June 2012	**JPY**	0.10%	-
Australia	3 July 2012	**AUD**	3.50%	-
South Africa	24 May 2012	**ZAR**	5.50%	-

Source: Momentum Global Investment Management / Lipper Hindsight. June 2012

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