momentum

Viewpoint

Monthly market update

October 2013

Global choice, wise decisions,
setting new benchmarks

global investment management

Contents

1. Market commentary 3

2. Market performance 5

3. Asset allocation dashboard 7

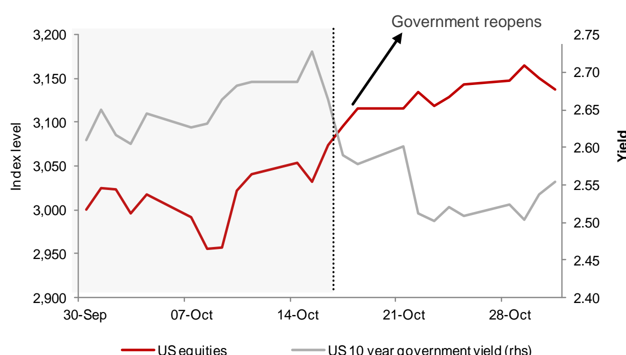
Important notes 9

1. Market commentary

Markets in October were dominated by events in the US. In the first half of the month the focus was almost entirely on the two main political parties, with the gulf between Republican and Democrat politicians resulting in the failure to agree a budget for the new fiscal year starting on 1 October and the first government shutdown in 17 years. The US debt ceiling of $16.7 trillion then needed raising by 17 October to prevent it being breached, an event which could have caused a technical default by the government. While default remained only a very small risk, markets were worried about the negotiations; in the event, politicians agreed on a last minute deal, enabling the government to reopen for business on 17 October. The deal only represents a short term compromise, however, with the government funded until 15 January and the debt ceiling raised until 7 February.

After sharp falls early in the month as the budget and debt ceiling talks faltered, markets became more confident that a deal would be struck and rallied strongly from 8 October onwards. Investors concluded that the negative impact to GDP growth as a result of the 17 day government shutdown, together with the potential hit to business and consumer confidence, would delay the Federal Reserve's (Fed's) tapering decision. Many investors also concluded that the Fed would not risk tapering ahead of the next round of budget and debt ceiling negotiations, which will conclude only in early February. This view was strengthened with President Obama's nomination of Janet Yellen as the next Fed Chair to succeed Bernanke in January. While widely expected, the appointment points towards a continuation of today's ultra-loose monetary policy, with Yellen the most dovish of the likely candidates for the position.

Figure 1: Government shutdown prompts investors to push back their expectations for the start of Fed tapering

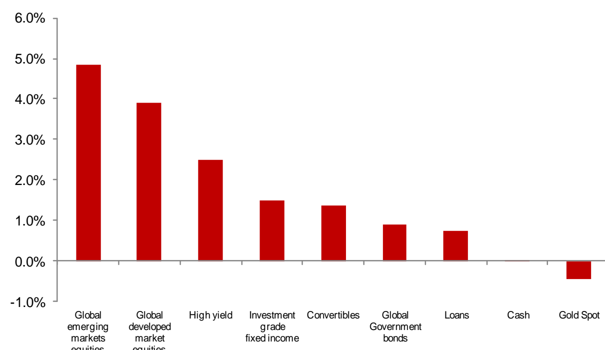


This view – that tapering will be delayed until well into next year – was further supported by data from the US (much of which was delayed by the government shutdown). Despite pockets of strength, economic data continues to point to a sluggish recovery, with jobs generation at much lower levels than in previous cycles. Payrolls numbers for September were disappointing at 148,000 (one Fed governor is quoted as saying that the central bank has a hurdle rate of 200,000 before it will consider tapering), and indications are that October's numbers will also be on the weak side. Consumer confidence fell sharply to 71.2 from 79.7 previously, and data from the housing industry suggested that the increase in mortgage rates over the past few months is having a meaningful impact, with pending home sales down in September for the fourth month in a row. Purchasing Managers' Indices disappointed and the ISM non manufacturing index fell to 54.4 from 58.6 previously. Importantly, inflation remains very subdued, with the Producer Price Index down by 0.1% in September, a factor that will almost certainly influence the Fed in its tapering decision.

Against this background, markets rapidly recovered the ground lost in the first week of the month, and the S&P 500 index moved to another all time high. Other markets followed, driven by the prospect of continued liquidity from the Fed alongside other major central banks. As a result, October was another strong month across nearly all asset classes except, once again, commodities. The MSCI World developed markets index returned 3.9% over the month, taking year to date gains to 21.9%. Returns in individual countries were all strong, with the US +4.6%, Europe +4.2% and the UK +4.3%, while Japan underperformed with a flat return over the month. Emerging markets continued their recovery post their midyear slide, with the MSCI Global Emerging Markets index adding 4.9% to leave it up by 0.3% year to date, still some 21% behind developed markets. Asian currencies also continued to recover after their earlier falls, with gains of 1-2%, but Latin American currencies – influenced more by trends in commodity markets – instead weakened by 1-2%. Bond markets, nervous during the debt ceiling talks, recovered and also produced good returns in the month, with US Treasury bonds +0.6% and the global government bond index +0.9%. Credit performed better than governments, with the broad investment grade index (which includes corporates as well as governments) +1.5% and US high yield +2.5%; finally

convertible bonds returned 2.2% to take their year to date returns to 15.4%. Commodities remained under pressure as continuing slow growth weighed on demand; the broad commodity index was down by 1.8% for the month, with precious metals flat to slightly down after gold slipped by 0.4%.

Figure 2: Asset class returns during October



Outside the US, the most significant data came from the Euro area in October, with disappointing forward looking indicators (notably PMIs) and much lower than expected inflation numbers. In peripheral Europe inflation fell into negative territory in Spain (-0.1% year-on-year) and to 0.7% in Italy; even Germany, boasting the strongest economy in Europe and an improving property market, saw inflation fall to 1.2% year-on-year. Unemployment across the Euro area rose to 12.2%, with youth unemployment at extremely high levels in much of peripheral Europe. All of this gave rise to fears of deflation and a Japanese-style 'lost decade'. Although some commentators pointed to the improving competitiveness of peripheral Europe as a result of falling inflation, the fact remains that Europe remains mired in a debt and austerity-induced deflationary environment, with growth likely to remain very sluggish for some time.

On a more positive note, data from China continued to suggest that the economy is stabilising after its slowdown over the past year. Third quarter GDP registered +7.8% year-on-year (up from 7.5% in Q2), industrial production +10.2% and fixed asset investment +20.2%. PMIs for the manufacturing sector reached a 14 month high of 56.3 (53.4 previously), whilst the service sector reached an 18 month high at 51.4. However, export numbers were weak, continuing the mixed picture from economies globally, and interbank rates firmed significantly through the month, with market talk of policy tightening to slow the increase in property prices across China – there have been price rises of over 20% in China's largest cities over the past year.

Central banks have dominated the news flow and the direction of markets for some time and this seems set to continue in the coming months. In particular, the timing of the Fed's decision to start tapering its monthly asset purchase programme and the pace at which it goes about this process will be a major factor behind the direction of markets. It is evident that the Fed is keen to begin normalising monetary policy, and to wean the markets off the liquidity feed. But equally, policymakers are anxious to avoid stopping the economic recovery before it reaches 'escape velocity'.

Given the headwinds to growth – namely high debt levels, fiscal imbalances and structural challenges in the emerging world – we have maintained the view for a long time that ultra loose monetary policy will continue well beyond the market's current expectations. There are still too many economic risks for the Fed and other central banks to rein in policy too soon. Risks, instead, will be taken on the side of keeping policy looser for longer, especially as inflation remains very subdued and expectations well anchored. While the prospect of Fed tapering and the US debt ceiling and budget negotiations to come in the new year will keep investors somewhat more nervous in the months ahead, it is important to remember that the reason for tapering will be an improving economy, which is good for the corporate sector and risk assets generally. Although equity valuations are higher than a year ago, as a result of generally strong markets, pockets of value still exist for the discerning investor.

Source: Bloomberg

2. Market performance

Asset class/region	Index	Currency	Month	Year to date
		To 31 October 2013		
Developed markets equities				
United States	S&P 500 NR	USD	4.6%	24.7%
United Kingdom	MSCI UK NR	GBP	4.3%	17.6%
Continental Europe	MSCI Europe ex UK NR	EUR	4.2%	19.8%
Japan	Topix TR	JPY	0.0%	41.4%
Asia Pacific (ex Japan)	MSCI Pacific ex Japan TR	USD	4.5%	10.0%
Global	MSCI World NR	USD	3.9%	21.9%
Emerging markets equities				
Emerging Europe	MSCI EM Europe NR	USD	4.9%	1.8%
Emerging Asia	MSCI EM Asia NR	USD	4.8%	3.1%
Emerging Latin America	MSCI EM Latin America NR	USD	4.8%	-7.0%
BRICs	MSCI BRIC NR	USD	4.8%	-0.6%
Global emerging markets	MSCI EM (Emerging Markets) NR	USD	4.9%	0.3%
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	0.6%	-1.9%
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	0.6%	-6.7%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	1.5%	-1.2%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	2.5%	6.3%
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	0.7%	-2.0%
UK Corporate (investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	GBP	1.7%	2.6%
Euro Government Bonds	Citigroup EMU GBI TR	EUR	1.4%	2.5%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	1.1%	2.6%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	EUR	2.6%	11.6%
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	0.7%	2.7%
Australian Government	JP Morgan Australia GBI TR	AUD	-0.4%	0.0%
Global Government Bonds	JP Morgan Global GBI	USD	0.9%	-2.4%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	1.0%	-0.7%
Global Convertible Bonds	UBS Global Convertible Bond	USD	2.2%	15.4%
Emerging Market Bonds	JP Morgan EMBI+	USD	2.7%	-6.4%

Source: Bloomberg

		To 31 October 2013		
Asset class/region	Index	Currency	Month	Year to date
Property				
US Property Securities	MSCI US REIT NR	USD	4.4%	6.8%
Australian Property Securities	S&P/ASX 200 A-REIT Index TR	AUD	2.6%	7.4%
Asia Property Securities	S&P Asia Property 40 Index NR	USD	0.2%	8.8%
Global Property Securities	S&P Global Property USD TR	USD	3.1%	7.9%
Currencies				
Euro		USD	0.4%	3.0%
UK Pound Sterling		USD	-0.9%	-1.3%
Japanese Yen		USD	-0.1%	-11.8%
Australian Dollar		USD	1.5%	-9.0%
South African Rand		USD	-0.2%	-15.7%
Commodities & Alternatives				
Commodities	RICI TR	USD	-1.8%	-4.9%
Agricultural Commodities	RICI Agriculture TR	USD	-2.5%	-10.4%
Oil	ICE Crude Oil CR	USD	0.5%	-1.0%
Gold	Gold Spot	USD	-0.4%	-21.0%
Hedge funds	HFRX Global Hedge Fund	USD	1.2%	5.5%
Interest rates			**Current rate**	**Change at meeting**
United States	30 October 2013	USD	0.25%	-
United Kingdom	10 October 2013	GBP	0.50%	-
Eurozone	2 October 2013	EUR	0.50%	-
Japan	31 October 2013	JPY	0.10%	-
Australia	1 October 2013	AUD	2.50%	-
South Africa	19 September 2013	ZAR	5.00%	-

[e] Estimate

3. Asset allocation dashboard

Positive	Neutral	Negative

Asset class	View
Equities	
Developed equities	Neutral
UK equities (relative to developed)	Positive
European equities (relative to developed)	Neutral
US equities (relative to developed)	Negative
Japan equities (relative to developed)	Neutral
Emerging market equities	Positive
Fixed Income	
Government	Negative
Index-linked (relative to government)	Negative
Investment grade (relative to government)	Positive
High yield	Neutral
Loans	Positive
Emerging market debt	Neutral
Convertible bonds	Neutral
Alternatives	
Commodities	Neutral
Hedge funds	Neutral
Property (UK)	Neutral
Currencies	
USD	Neutral
Euro	Negative
Yen	Negative
Emerging market currencies	Neutral

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