momentum

Viewpoint

Monthly market update

January 2013

Global choice, wise decisions, setting new benchmarks

global investment management

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1. Market commentary

Markets picked up where they left off at the end of 2012, with strong returns from assets including equities and high yield credit during January. Global equities added 5.1% last month, their best performance since June 2012, whereas core government bonds fell by 1.5%. Whilst it is too early to begin speculating about a *'great rotation'* from fixed interest securities into equities, we have written extensively about the significant imbalances we continue to see between asset classes. The 12 month trailing dividend yield on the S&P 500 index has been above the 10 year treasury yield since August 2011. Whilst this first measure (i.e. dividends) builds in a degree of inflation protection and has the ability to grow over time, treasury yields represent a nominal return that is guaranteed to lose value in real terms when the cumulative effects of inflation are taken into account.

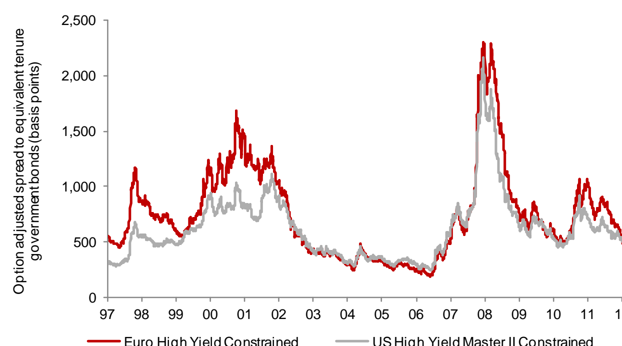
Figure 1: Imbalances continue to exist between asset classes

Government bonds have posted negative returns in only three years since 1986 (1999; 2001; 2005). With interest rates in the US declining from 9% at the start of the period to a low of 1.4% in July 2012, investors have been rewarded for bearing interest rate risk over this period. A rising interest rate environment would bring with it a very different set of challenges for fixed income investors.

Developed markets led the way from their emerging counterparts during January, with the MSCI World index rising by 5.1%. Emerging markets (EM) returned the lower 1.4% over the period, despite no net movement in the EM currency basket versus the US dollar. The Indian rupee and Brazilian real both appreciated by around 3% versus the dollar, but their domestic stock markets lagged peers. Returns in EM showed a wide dispersion, with Chinese equities up by 5%, whilst Brazil instead fell by 2%. In contrast, all major developed markets delivered positive returns over the month, led by Japan with gains of 9.4% in local currency terms. The UK rallied by 6.4% in sterling terms last month, whilst the US delivered solid returns of 5.1%, after the energy sector added 7.8%.

The performance of global equities and fixed income securities diverged at the start of the new year, with 'safe haven' government bonds (including the US, the UK and Germany) producing negative returns of between 0.5 and 2 per cent, as yields moved higher. In turn, rising interest rates had an impact on credit, with high grade corporate bonds only marginally outperforming governments, whilst high yield returned 1.3% as spreads tightened further.

Figure 2: High yield credit spreads contracting in Europe and the US during January



In currencies, the euro was firmer against the US dollar (up 2.9% to 1.36 dollars to the euro), whilst sterling slipped by 2.4%, after initial estimates showed the UK economy shrinking by more than expected during the fourth quarter (-0.3% versus -0.1% expected). The yen fell by a further 5.5% versus the US dollar to 92 yen to the dollar, as authorities in Japan continued their aggressive action designed, in part, to curb the value of the currency.

Following the last minute 'fiscal cliff' deal in the US, the risk of a complete impasse and a fiscal tightening of up to 4% of GDP is off the table for now, although negotiations over government spending will resume in mid May. This, together with a steady stream of

Source: Bloomberg. Returns in US dollars unless otherwise stated. January 2013.

positive numbers from the US economy, helped to lift investor sentiment at the start of the new year. The market did not dwell on the latest growth figures, which showed the US economy contracting by 0.1% between September and December; the first quarter-on-quarter decline in output since 2009. The majority of commentators adjudged the factors behind the latest reading to be one-off, with reduced defence spending and reduced inventories each accounting for over 1% of the gross decline. On the positive side, durable goods orders were strong in December, Purchasing Managers' Indices (PMIs) showed a rise in manufacturing activity and personal incomes grew at their fastest pace in eight years. There was also evidence of a pickup in business capital investment. Overall, confidence in the US recovery appears to be gradually improving, despite the growth outlook remaining relatively subdued.

In China, news was also broadly positive last month, after figures showed GDP expanding by 7.9% in 2012, reinforcing the view that Beijing has successfully managed a 'soft landing' for the economy. Industrial production grew by 10.3% year-on-year in December, whilst retail sales rose by 15.2%. The economy appears to have moved out of the soft patch that weighed on investor sentiment in 2012, with early signs of rising domestic consumption.

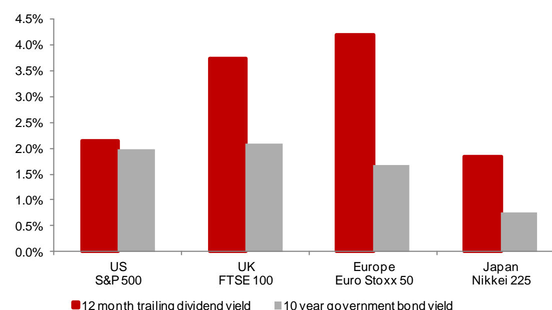
In the corporate sector, earnings season has started well, with companies continuing to monitor costs and spending carefully. With 80% of companies having reported in the US so far, the latest quarter looks set to be significantly better than the previous two. Company chiefs have also expressed cautious optimism about the prospects for the coming year.

The most significant developments last month were in Japan, after the newly elected Liberal Democratic Party moved to fulfil its pre-election commitments to pull the economy out of its deflationary era. The government announced a JPY 10 trillion fiscal stimulus programme during January, focused on infrastructure and in particular maintenance and renewal, alongside measures to boost competitiveness and the growth potential of the economy. Taking its lead from the government, the Bank of Japan (BoJ) announced it will formally adopt a 2% inflation target (up from 1% previously) and introduce an open-ended asset purchase programme to replace the current programme when it runs out in January 2014. This is the first time the BoJ has introduced an open-ended programme, similar in principle to that of the Federal Reserve. Together these actions have prompted a sharp weakening of the yen, which in turn can be expected to substantially boost corporate profitability in Japan as a result of the high proportion of exporters. The stock market has reacted positively, up by over 30% since its mid November low.

In Europe, the rapid turnaround in fortunes of peripheral bond markets and easing fears of a euro collapse (indeed, the euro is up by over 13% against the US dollar since Mario Draghi's *'we will do whatever it takes'* speech in July) has enabled a large number of European banks to start repaying funds borrowed under the European Central Bank's (ECB's) Long Term Refinancing Operations in late 2011/ early 2012. German one year bills were sold with a positive interest rate for the first time since June 2012 at auction in January, whilst the ECB talked about conditions being right for a gradual recovery later this year.

News has been generally positive for markets in recent weeks. Many of the biggest risks facing investors in the near term have been allayed or removed entirely. Markets have reacted accordingly, with more economically sensitive assets performing well, led by equities, whilst safe haven assets have lagged behind. There is growing speculation about a great rotation from bonds to equities, following the bond bull market of the past 30 years. Core government bond yields are now at exceptionally low levels, raising the risk of capital losses for bond holders in the event that interest rates begin to revert back towards their historical norms. In contrast, equities continue to offer value in terms of dividend and cash flow yields, and hence room for further capital appreciation.

Figure 3: Dividend yields remain attractive in developed markets



Source: Bloomberg. Returns in US dollars unless otherwise stated. January 2013.

As ever, it is worth emphasising that the process of deleveraging and rebalancing – which has been underway since the start of the global financial crisis – has some way to go yet. This will keep growth relatively subdued and competitive conditions for companies will remain tough. While risks have been reduced, in most instances they are yet to be eliminated. The US faces the debt ceiling and a long period of fiscal tightening; Europe is still mired in recession and faces important elections in Italy in the coming days; credit remains tight and banks (particularly in Europe) are still undercapitalised. Even a modest shock, such as unrest in the Middle East, could be very destabilising.

While we remain constructive for equity markets and see further progress this year (underpinned by huge liquidity from central banks, a modest growth pick up and a very strong corporate sector), we are conscious that there has been a sharp move already since mid 2012 and a lot of the good news has now been incorporated into market valuations. As such, we are mindful of the risk of a period of consolidation in the near term, before markets resume their upward move later in the year.

Source: Bloomberg. Returns in US dollars unless otherwise stated. January 2013.

2. Market performance

Asset class/region	Index	To 31 January 2013		
		Currency	Month	2012
Developed markets equities				
United States	S&P 500 NR	USD	5.1%	15.2%
United Kingdom	FTSE All Share TR	GBP	6.4%	12.3%
Continental Europe	MSCI Europe ex UK NR	EUR	3.8%	19.4%
Japan	Topix TR	JPY	9.4% e	20.9% e
Asia Pacific (ex Japan)	MSCI Pacific ex Japan TR	USD	5.1%	24.7%
Global	MSCI World NR	USD	5.1%	15.8%
Emerging markets equities				
Emerging Europe	MSCI EM Europe NR	USD	3.7%	24.3%
Emerging Asia	MSCI EM Asia NR	USD	1.1%	20.8%
Emerging Latin America	MSCI EM Latin America NR	USD	3.7%	8.7%
BRICs	MSCI BRIC NR	USD	4.2%	14.5%
Global emerging markets	MSCI EM (Emerging Markets) NR	USD	1.4%	18.2%
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	-1.0%	2.2%
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	-0.8%	7.3%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	-0.9%	9.8%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	1.3%	15.8%
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	-1.9%	2.6%
UK Corporate (investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	GBP	-1.0%	13.3%
Euro Government Bonds	Citigroup EMU GBI TR	EUR	-0.5%	10.7%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	-1.2%	13.6%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	EUR	3.2%	29.4%
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	0.3%	1.8%
Australian Government	JP Morgan Australia GBI TR	AUD	-0.5%	5.7%
Global Government Bonds	JP Morgan Global GBI	USD	-1.5%	1.3%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	-0.7%	4.1%
Global Convertible Bonds	UBS Global Convertible Bond	USD	2.8%	13.3%
Emerging Market Bonds	JP Morgan EMBI+	USD	-2.1%	18.0%

e – Estimate
Source: Bloomberg. January 2013.

		To 31 January 2013		
Asset class/region	Index	Currency	Month	2012
Property				
US Property Securities	MSCI US REIT NR	USD	3.7%	16.5%
UK Property Securities	FTSE EPRA/NAREIT United Kingdom TR	GBP	1.0%	29.9%
Europe ex UK Property Securities	FTSE EPRA/NAREIT Developed Europe ex UK TR	EUR	-1.0%	25.9%
Australian Property Securities	FTSE EPRA/NAREIT Australia TR	AUD	4.5%	32.2%
Asia Property Securities	FTSE EPRA/NAREIT Developed Asia TR	USD	3.9%	45.5%
Global Property Securities	FTSE EPRA/NAREIT Developed TR	USD	3.2%	28.7%
Currencies				
Euro		USD	2.9%	1.8%
UK Pound Sterling		USD	-2.4%	4.5%
Japanese Yen		USD	-5.5%	-11.3%
Australian Dollar		USD	0.3%	1.9%
South African Rand		USD	-5.4%	-4.6%
Commodities & Alternatives				
Commodities	RICI TR	USD	4.0%	2.0%
Agricultural Commodities	RICI Agriculture TR	USD	2.9%	1.8%
Oil	ICE Crude Oil CR	USD	3.9%	2.8%
Gold	Gold Spot	USD	-0.7%	7.1%
Hedge funds	HFRX Global Hedge Fund	USD	2.0%	3.5%
Interest rates			**Current rate**	**Change at meeting**
United States	30 January 2013	USD	0.25%	-
United Kingdom	7 February 2013	GBP	0.50%	-
Eurozone	7 February 2013	EUR	0.75%	-
Japan	14 February 2013	JPY	0.10%	-
Australia	5 February 2013	AUD	3.00%	-
South Africa	24 January 2013	ZAR	5.00%	-

[e] Estimate

Source: Bloomberg. January 2013.

3. Asset allocation dashboard

Positive (green)	Neutral (amber)	Negative (red)

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)	Neutral
Investment grade (relative to government)	Positive
High yield	Positive
Loans	Positive
Emerging market debt	Neutral
Convertible bonds	Neutral
Alternatives	
Commodities	Neutral
Hedge funds	Neutral
Property (UK)	Neutral
Currencies	
Dollar	Neutral
Euro	Negative
Yen	Negative
Emerging market currencies	Neutral

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Under our multi-management arrangements, we selectively appoint underlying sub-investment managers and funds to actively manage underlying asset holdings in the pursuit of achieving mandated performance objectives. Annual investment management fees are payable both to the multimanager and the manager of the underlying assets at rates contained in the offering documents of the relevant portfolios (and may involve performance fees where expressly indicated therein).

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