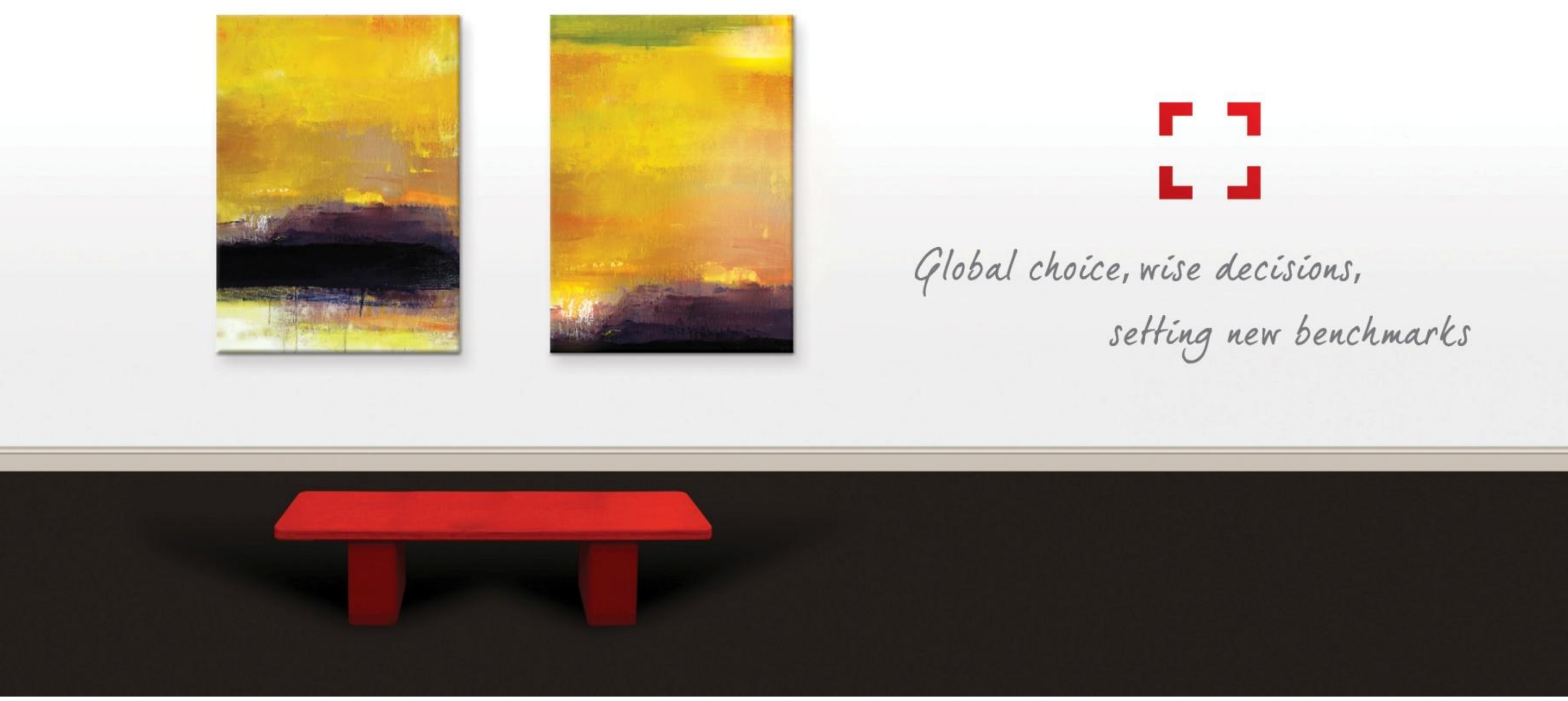
momentum

Viewpoint

Monthly market update

June 2013



global investment management

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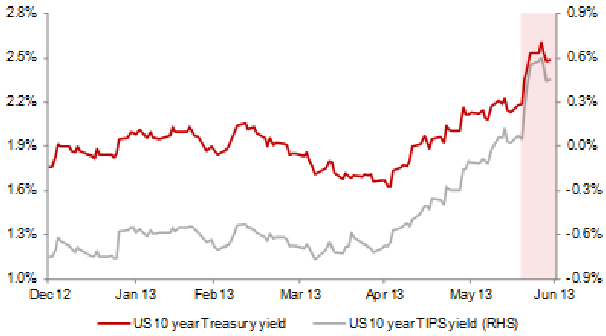
1. Market commentary

The selloff that started in late May continued through June, with nearly all asset classes suffering sharp falls. In a busy month for data and news, there were two key developments for investors to contend with; namely US central bank ‘tapering’ and the apparent slowdown in Chinese growth.

Investor concerns around tapering were heightened following the Federal Open Market Committee meeting during the third week of the month, with Chairman Ben Bernanke adopting an uncharacteristically hawkish tone. In its updated economic forecasts the Federal Reserve (Fed) reduced its expected unemployment range to between 6.5 and 6.8% by the end of next year, and to 5.8-6.2% by the end of 2015, below the critical 6.5% level which has been set as the threshold for the start of monetary tightening. It also reduced its inflation forecast for 2013 to between 1.2 and 1.3%. In light of broadly encouraging data from the economy the Fed announced that tapering of its asset purchase programme would start before the end of 2013 and end by mid 2014 if the economy continues on its current path. The market took this to mean that tapering would start in September, triggering a rush to sell bonds and other asset classes that have been the big beneficiaries of central bank liquidity. Gold and commodities, emerging market equities and bonds were the clear losers from this process. However the Fed also emphasised that the tapering of its monthly asset purchase programme remains independent from any decision on interest rates, which it expects to remain at their current floor for an extended period. Furthermore, the Fed emphasised the importance of ‘data over date’; its final decision on tapering will be entirely data dependent, meaning that if the economy slows the central bank stands ready to increase asset purchases and/or delay any planned tapering.

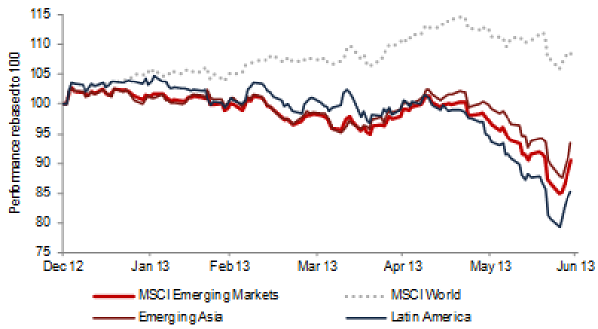
The impact of Bernanke’s statement was immediate, with big falls seen across the majority of asset classes. The yield on the 10 year US Treasury rose to 2.6%, a full 1% above its lows of early May and its highest level in almost two years. This affected bond markets around the world, with falls observed across the credit spectrum. Over the month US government bonds returned -1.3%, investment grade corporate bonds -2.8% and US high yield -2.6%. Similar falls were seen elsewhere with the exception of Japan which was stable (yields having already doubled from 0.4% to 0.8% earlier in the year). Global government bonds fell by 0.7% over the month, taking their year to date returns to -5.8%. US Treasury Inflation Protected Securities (TIPS) suffered a poor month, down by 3.8%, as inflation expectations fell sharply. The biggest falls however were reserved for Emerging Market debt, which has been the beneficiary of large inflows during this most recent period of excess liquidity.

Figure 1: Yields on government bonds spike upwards following the FOMC statement



Equities also sold off with the MSCI World index down by 2.5% for the month. Regional performance was mixed with the US holding up relatively well (-1.4%), Japan steady and Europe and the UK down by 5% in their respective local currencies. However, as in bond markets, the biggest falls were seen in emerging markets: the MSCI Global Emerging Markets index declined by 6.4% in June, continuing its sizeable underperformance relative to developed markets. All regions fell sharply but Latin America was the worst hit, down by 9%, with falls in commodity markets and political unrest in Brazil hitting both sentiment and growth.

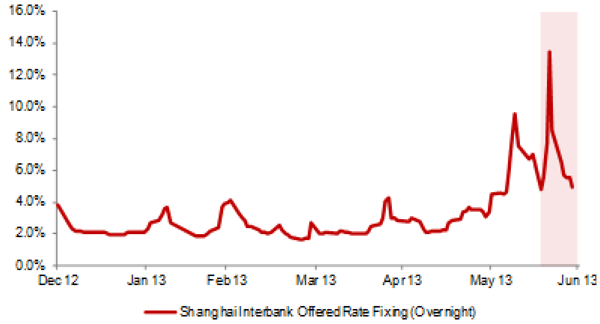
Figure 2: Performance of emerging markets in 2013 (US dollar terms)



The most notable falls came in commodities and precious metals. Gold fell by around 10% immediately following the Fed's statement and was down by 11% for the month (-26.3% year to date). Silver fell even further and is now down by 35% so far this year. Industrial metals followed closely behind, with copper down by 7.4% in June (-16.5% year to date). Only oil held up, rising by 0.6% in June as unrest in Egypt fanned concerns about the stability of Middle East supplies.

The second major driver behind markets in June was China, where evidence of a significant slowdown in growth continued to mount and credit conditions tightened substantially over the month. On the data front, export growth fell to 1%, inflation eased to 2.1% from 2.4% previously, there was slippage in industrial production growth and retail sales and June PMIs (Purchasing Managers' Indices) were disappointing in both manufacturing and services. However, the biggest immediate concern for investors was the spike in interbank lending rates, which peaked at over 12%. There was much debate about the cause of the spike but the most credible explanation seems to be that the People's Bank of China (PBoC) had sent a message to banks that excess credit creation needs to be reined in. Outstanding credit was up 22% in May and is now close to 200% of GDP versus 130% in 2008. Much of the credit has come from the shadow banking sector with so called Wealth Management Products (WMPs) booming. The PBoC is now tightening the rules on issuance of WMPs and reining in growth of shadow finance by constraining liquidity available to fund new credit extension. These actions will slow credit growth and increase the risks of a further slowdown in the economy, a fact not lost on markets as commodity and related assets such as the Australian dollar (-4.5% in June; -12.1% year to date) fell sharply. As the pressure on interbank rates grew the PBoC eventually stepped in to calm markets and supply liquidity. All of this follows the change of guard at the top of the Communist Party with the new leaders cutting out conspicuous consumption and focusing on the need to rebalance the economy; a process which they recognise will be long and difficult.

Figure 3: Chinese interbank lending rates climb a spike in June



Evidence continued to build during June of a gradual and modest pickup in activity in the developed world while growth in the emerging world continues to slow significantly. Apart from the now clear signs of a slowdown in China, other big emerging market (EM) countries have been hit by slower growth and weakening currencies. India has seen its currency fall to an all time low, Brazil has lifted capital controls on inflows and its economy has weakened with industrial production in May down by 2%. Political unrest and protests across Brazil, Turkey, Egypt and continuing instability in Syria added to EM investor worries. In contrast, news on growth from the developed world was better. The US has managed to post reasonable growth despite a sharp fiscal contraction, with sequestration and fiscal tightening estimated to take 1.5% out of growth in the first half of this year. Although first quarter GDP growth was revised down to 1.8%, other indicators point to continuing modest expansion. Elsewhere, the economic recovery appears to be taking root in the UK, with services growing at their fastest pace in a year in May, following strong readings for both manufacturing and construction. Japan is also improving following the Abe measures; while there was some disappointment with the third arrow of Abe's reform – namely structural changes and the liberalisation of certain sectors of the economy – there is no doubt that confidence has improved dramatically in Japan and the economy appears set for good growth this year. There has also been evidence of a slight uptick in Europe, with PMIs in the Eurozone rising to 48.9 in June; still below the 50 threshold but the third consecutive rise to reach a 15 month high.

The issue which is likely to have by far the biggest impact on markets in coming months, however, is the decision to be made at the Fed over reducing the rate of quantitative easing. The decision to taper will be entirely data dependent, meaning markets will remain highly sensitive to news on the economy. It is possible that the Fed, with its hawkish approach at the June meeting, was testing the markets to judge the reaction from investors to the prospect of reining in asset purchases. If so, they will be very cautious about the timing and pace of tapering given the extent and speed of the selloff. It is quite possible that tapering will not commence until late 2013, especially given the headwinds to growth from fiscal tightening this year. The Fed will certainly not wish to jeopardise the nascent recovery in the housing market and the economy generally. It is important to remember that the Fed will initially taper rather than stopping asset purchases outright, and so policy will remain very loose for another year at least whilst interest rates will not be raised for a further period, possibly as long as two years from now. At the same time, bond market investors have received a wakeup call; the sharp back-up in yields illustrates the extent to which bond markets have become dependent on ultra loose monetary policy and eventually interest rates will normalise.

The falls in equity markets are providing valuation opportunities. While we had been expecting a correction after the sharp rises over the past year, the moves in some markets have been sudden and quite steep, especially in sectors such as utilities, infrastructure and telecoms, that have been viewed as bond surrogates. Given that the reason for tapering will be an improving economy, which is good for the corporate sector, equities seem to be better supported than bonds in the current market environment. As long as monetary policy is loose in the developed world and the Fed reins in its purchases only gradually (as expected), equity markets should make further progress in coming months and hence weakness represents a buying opportunity.

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

2. Market performance

		To 28 June 2013		
Asset class/region	Index	Currency	Month	Year to date
Developed markets equities				
United States	S&P 500 NR	USD	-1.4%	13.5%
United Kingdom	FTSE All Share TR	GBP	-5.0%	8.5%
Continental Europe	MSCI Europe ex UK NR	EUR	-4.9%	4.7%
Japan	Topix TR	JPY	0.0%	33.3% e
Asia Pacific (ex Japan)	MSCI Pacific ex Japan TR	USD	-5.9%	-4.6%
Global	MSCI World NR	USD	-2.5%	8.4%
Emerging markets equities				
Emerging Europe	MSCI EM Europe NR	USD	-6.9%	-11.5%
Emerging Asia	MSCI EM Asia NR	USD	-5.9%	-6.6%
Emerging Latin America	MSCI EM Latin America NR	USD	-9.0%	-14.8%
BRICs	MSCI BRIC NR	USD	-8.1%	-12.6%
Global emerging markets	MSCI EM (Emerging Markets) NR	USD	-6.4%	-9.6%
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	-1.3%	-2.5%
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	-3.8%	-7.8%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	-2.8%	-3.4%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	-2.6%	1.4%
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	-2.4%	-3.2%
UK Corporate (investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	GBP	-3.8%	-1.4%
Euro Government Bonds	Citigroup EMU GBI TR	EUR	-1.5%	0.1%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	-1.6%	0.1%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	EUR	-1.8%	0.6%
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	0.0%	0.6%
Australian Government	JP Morgan Australia GBI TR	AUD	-1.4%	-0.3%
Global Government Bonds	JP Morgan Global GBI	USD	-0.7%	-5.8%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	-1.0%	-4.4%
Global Convertible Bonds	UBS Global Convertible Bond	USD	-1.6%	5.4%
Emerging Market Bonds	JP Morgan EMBI+	USD	-5.3%	-9.4%

Source: Bloomberg. June 2013.

		To 28 June 2013		
Asset class/region	Index	Currency	Month	Year to date
Property				
US Property Securities	MSCI US REIT NR	USD	-2.1%	5.8%
UK Property Securities	FTSE EPRA/NAREIT United Kingdom TR	GBP	-4.3%	9.5%
Europe ex UK Property Securities	FTSE EPRA/NAREIT Developed Europe ex UK TR	EUR	-7.0%	-0.5%
Australian Property Securities	FTSE EPRA/NAREIT Australia TR	AUD	-0.9%	8.5%
Asia Property Securities	FTSE EPRA/NAREIT Developed Asia TR	USD	-1.9%	0.1%
Global Property Securities	FTSE EPRA/NAREIT Developed TR	USD	-2.7%	2.4%
Currencies				
Euro		USD	0.1%	-1.4%
UK Pound Sterling		USD	0.1%	-6.4%
Japanese Yen		USD	1.4%	-12.5%
Australian Dollar		USD	-4.5%	-12.1%
South African Rand		USD	2.1%	-14.2%
Commodities & Alternatives				
Commodities	RICI TR	USD	-2.3%	-7.2%
Agricultural Commodities	RICI Agriculture TR	USD	-4.2%	-7.9%
Oil	ICE Crude Oil CR	USD	0.6%	-7.3%
Gold	Gold Spot	USD	-11.0%	-26.3%
Hedge funds	HFRX Global Hedge Fund	USD	-1.3%	3.2%
Interest rates			**Current rate**	**Change at meeting**
United States	19 June 2013	USD	0.25%	-
United Kingdom	4 July 2013	GBP	0.50%	-
Eurozone	4 July 2013	EUR	0.50%	-
Japan	11 July 2013	JPY	0.10%	-
Australia	2 July 2013	AUD	2.75%	-
South Africa	23 May 2013	ZAR	5.00%	-

[e] Estimate

Source: Bloomberg. June 2013.

3. Asset allocation dashboard

🟢 Positive	🟡 Neutral	🔴 Negative

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

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