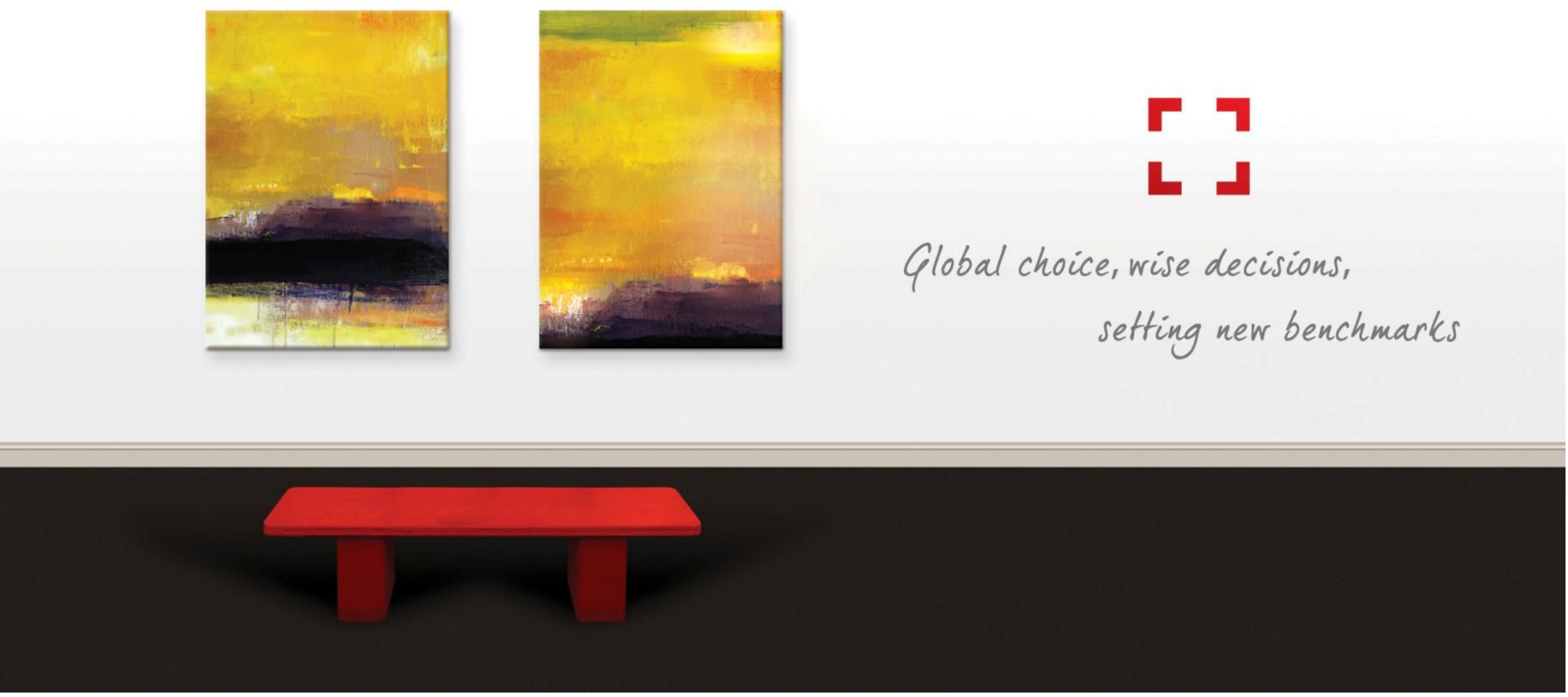
momentum

Viewpoint

Monthly market update

December 2013



global investment management

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1. Market commentary

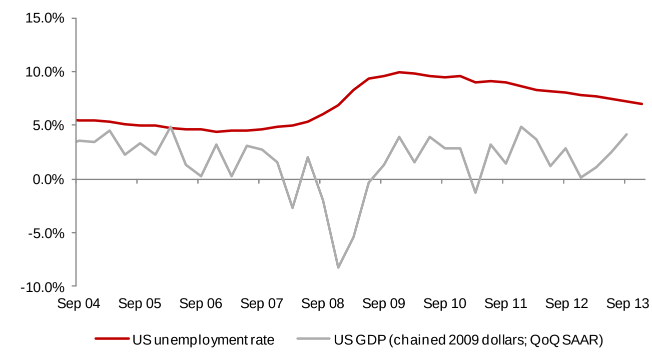
Markets traded sideways ahead of the Federal Reserve's (Fed) meeting on the 17th of December, before staging a strong rally into the year end. Appropriately, given what had gone before for much of the year, December was another month defined by the actions of central banks, and once again the news served to push equity markets higher.

At its monthly meeting, the Federal Reserve (Fed) announced it would start tapering quantitative easing (QE) based on its assessment of the strength of the economic recovery in the US. After several months of speculation, the central bank announced it would scale back its USD 85 billion a month asset purchase programme by USD 10 billion a month, with USD 5 billion coming from both US treasury purchases and mortgage backed securities.

Meanwhile the Bank of England elected to keep policy unchanged – although it has not increased its stock of assets since July 2012 – as did the European Central Bank, with interest rates on hold at a record low of 0.25% following November's surprise cut of a quarter of a percent. Forward looking indicators in much of the Eurozone have improved over the past quarter (the Eurozone Manufacturing Purchasing Managers' Index has now been above 50 for the last six months), although the threat of deflation remains a concern. German Chancellor Angela Merkel was elected to serve for a third term during December, after receiving just over 70% of the vote in the 631-member Bundestag. After failing to gain a majority in September's general election, Merkel's centre-right Christian Democratic Union/Christian Social Union (CDU/CSU) party formed a coalition with the centre-left Social Democratic Party, whose leader Sigmar Gabriel was also appointed to the dual post of Economy Minister and Deputy Chancellor.

The US economy grew at a revised rate of 4.1% in the third quarter, according to the US Commerce Department, marking the fastest pace of growth since 2011. Unemployment has fallen by 0.5% over the quarter to 6.7%, although the Federal Reserve has been keen to play down the significance of the 6.5% target unemployment level introduced in December 2012.

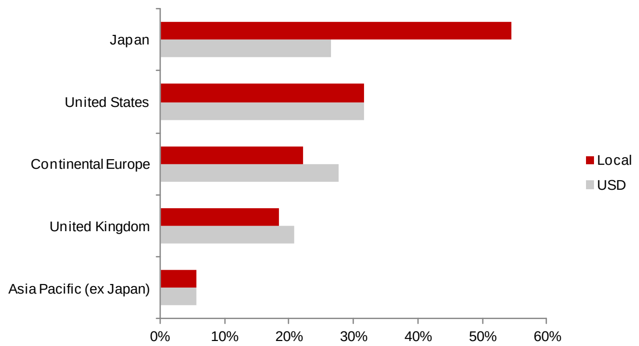
Figure 1: US real GDP and unemployment rate



Negotiations saw the first bipartisan budget deal in four years successfully pass through the US House of Representatives at the start of the month. The budget proposal, after being ratified by the Senate, was approved by President Obama on 26 December, and removes the risk of a further US government shutdown in mid-January. The budget bill, which outlines a two year plan aimed at reducing the country's annual budget deficit by USD 23 billion, sets government spending at USD 1.012 trillion for the current fiscal year.

Global equities returned 2.1% in December, to bring their full year returns to 26.7% – the best year for developed market equities since 2009. Japan was the best performing market in local currency terms, but the Topix index's return of 3.6% over the month in yen terms was trimmed to 1.0% in US dollar terms, after the yen depreciated by a further 2.7% versus the dollar. The US returned 2.5%, the UK 1.6% (GBP) and Continental Europe 0.8% (EUR), whilst Asia Pacific (ex Japan) fell by 1.2%. Global emerging markets on the other hand declined by 1.4% to round off a disappointing year for investors in the asset class.

Figure 2: Performance of major developed market equities in 2013



In fixed income markets, government bonds sold off in response to the prospect of lower demand from central banks, with US Treasuries returning -1.1%, UK gilts -1.3% (GBP) and Japanese government bonds -0.6% (JPY). High yield credit in the US returned 0.5% and 1.9% in Europe (EUR), to round off an impressive year for lower rated debt securities.

Commodities added 1.6% in December, while nonetheless down for the year, and gold fell by a further 3.8% to bring full year returns to -28.0%, the worst year for the precious metal since 1981.

Reflecting on the year as a whole, the big story for investors was the outperformance of leading DM equity markets versus EM equities and safe haven government bonds, both of which suffered negative returns over the year (MSCI World +26.7%; MSCI EM -2.6%; government bonds -4.5%). In general there were had favourable conditions for equities in the past year: monetary policy has been exceptionally loose and accommodating in all the big developed markets, credit conditions have eased especially in the US and the UK and to a lesser extent in Japan, inflation has been subdued, economies have been sluggish but recovering as the year progressed, and corporate profitability has been very good with profit margins at historically high levels.

Given a continuation of today's steady – albeit relatively slow – economic recovery, the environment for the corporate sector remains good. However, we do not expect a repeat of 2013's returns in developed markets; equity prices have moved ahead of underlying earnings and although valuations are not yet stretched they are no longer as compelling as they were.

Central banks have dominated the news flow and the direction of markets for some time and this seems set to continue in 2014. In particular the pace of the Fed's tapering will be a major driver behind the markets, as it attempts to create more normal monetary conditions and wean the markets off today's liquidity without stopping the economic recovery before it reaches 'escape velocity'. We have maintained the view for a long time that ultra loose monetary policy will continue well beyond the market's current expectations, and we continue to expect risks to be taken on the side of keeping policy looser for longer, especially as inflation remains subdued.

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

2. Market performance

		To 31 December 2013		
Asset class/region	Index	Currency	Month	Year to date
Developed markets equities				
United States	S&P 500 NR	USD	2.5%	31.5%
United Kingdom	MSCI UK NR	GBP	1.6%	18.4%
Continental Europe	MSCI Europe ex UK NR	EUR	0.8%	22.1%
Japan	Topix TR	JPY	3.6% [e]	54.4% [e]
Asia Pacific (ex Japan)	MSCI Pacific ex Japan TR	USD	-1.2%	5.6%
Global	MSCI World NR	USD	2.1%	26.7%
Emerging markets equities				
Emerging Europe	MSCI EM Europe NR	USD	-2.6%	-4.5%
Emerging Asia	MSCI EM Asia NR	USD	-1.3%	2.0%
Emerging Latin America	MSCI EM Latin America NR	USD	-2.4%	-13.4%
BRICs	MSCI BRIC NR	USD	-2.1%	-3.5%
Global emerging markets	MSCI EM (Emerging Markets) NR	USD	-1.4%	-2.6%
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	-1.1%	-3.4%
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	-1.5%	-9.3%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	-0.2%	-1.5%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	0.5%	7.4%
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	-1.3%	-4.2%
UK Corporate (investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	GBP	-1.0%	0.8%
Euro Government Bonds	Citigroup EMU GBI TR	EUR	-0.6%	2.2%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	-0.4%	2.4%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	EUR	1.9%	15.0%
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	-0.6%	2.2%
Australian Government	JP Morgan Australia GBI TR	AUD	0.5%	0.0%
Global Government Bonds	JP Morgan Global GBI	USD	-1.0%	-4.5%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	-0.5%	-2.0%
Global Convertible Bonds	UBS Global Convertible Bond	USD	1.4%	18.2%
Emerging Market Bonds	JP Morgan EMBI+	USD	0.5% [e]	-8.3%

Source: Bloomberg

		To 31 December 2013		
Asset class/region	Index	Currency	Month	Year to date
Property				
US Property Securities	MSCI US REIT NR	USD	0.1%	1.3%
Australian Property Securities	S&P/ASX 200 A-REIT Index TR	AUD	-3.1%	1.1%
Asia Property Securities	S&P Asia Property 40 Index NR	USD	-0.7%	6.5%
Global Property Securities	S&P Global Property USD TR	USD	-0.3%	3.7%
Currencies				
Euro		USD	1.1%	4.2%
UK Pound Sterling		USD	1.1%	1.9%
Japanese Yen		USD	-2.7%	-17.6%
Australian Dollar		USD	-2.1%	-14.2%
South African Rand		USD	-3.1%	-19.4%
Commodities & Alternatives				
Commodities	RICI TR	USD	1.6%	-4.5%
Agricultural Commodities	RICI Agriculture TR	USD	-1.6%	-11.1%
Oil	ICE Crude Oil CR	USD	0.4%	0.9%
Gold	Gold Spot	USD	-3.8%	-28.0%
Hedge funds	HFRX Global Hedge Fund	USD	0.6%	6.7%
Interest rates			**Current rate**	**Change at meeting**
United States	18 December 2013	USD	0.25%	-
United Kingdom	5 December 2013	GBP	0.50%	-
Eurozone	5 December 2013	EUR	0.25%	-
Japan	20 December 2013	JPY	0.10%	-
Australia	3 December 2013	AUD	2.50%	-
South Africa	21 November 2013	ZAR	5.00%	-

e Estimate

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	
GBP	🟡
Euro	🔴
Yen	🔴
Emerging market currencies	🟡

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