

Viewpoint

Monthly market update

July 2014



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1. Market commentary

A series of largely unrelated events led to increased market nervousness in July, which culminated in a sell-off on Wall Street of circa 2% on the last day of the month. This was the biggest single day fall for three months and broke the pervading calm which has been a key characteristic of markets this year. The sell-off resulted in the MSCI World falling 1.6% in July with only Japan (+2.1% in yen terms) and Asia excluding Japan (+3.5% in US dollar terms) producing positive returns. Global returns translated into US dollar terms were also negatively affected by the strength of the greenback, with the euro falling by 2.2%, sterling by 1.3% and yen by 1.4%, against the US dollar. The Chicago Board Options Exchange (CBOE) VIX index of implied volatility rose sharply, bucking the trend of falling volatility year-to-date.

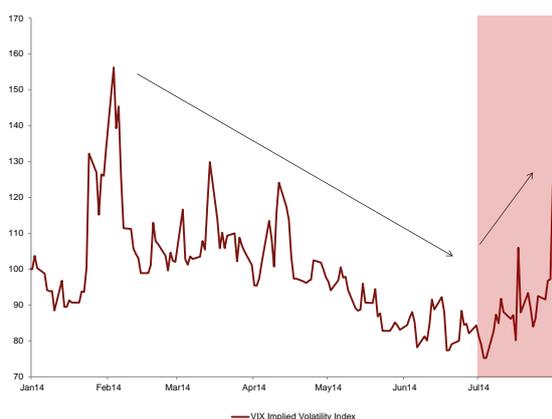


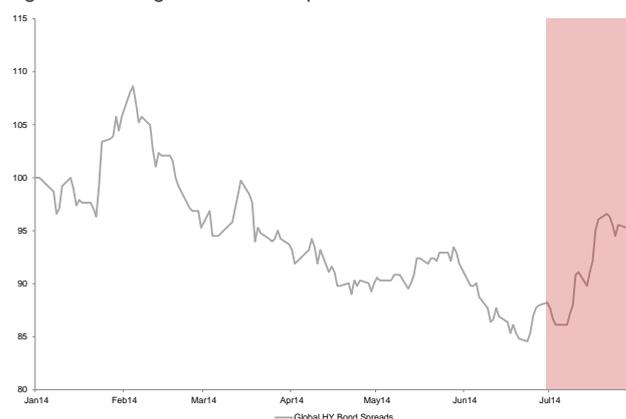
Figure 1: (CBOE) VIX index of implied volatility

In contrast, strength in emerging equity markets (EM) early in the month, especially in Asia and Latin America, was enough to keep the MSCI Global Emerging Markets index in positive territory for July. EM equities returned +1.9% bringing their return to +8.2% year-to-date. This puts EM equities well ahead of their developed market counterparts, which have returned 4.5% year-to-date.

There were some divergent returns from bond markets in July. Whereas European government markets were firm, US Treasuries slipped late in the month on the strong growth numbers and returned -0.2%. However, it was in credit that the most notable returns came. Investment grade credit performed broadly in line with governments but US high yield bonds saw a sharp sell-off and returned -1.3% in the month. July saw large outflows from US high yield exchange traded products (ETFs), with a net outflow

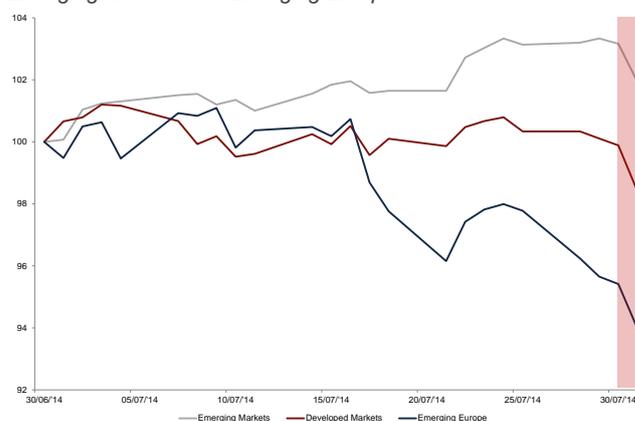
of over USD 10 billion which is around 3% of the total assets under management of these funds. Emerging market debt continued to perform satisfactorily, with a small positive return, despite the mini default of Argentina, which markets had been pricing in for some time.

Figure 2: US High Yield Bond Spreads



Geopolitics has occupied investors throughout this year, but became an increasing concern during July, following the downing by Russian supported separatists of the passenger plane MH17 over Ukraine. Following this, there was a significant tightening of sanctions imposed on Russia by the US and Europe which may start having a material impact on a number of companies in the West. The Russian market fell by 8.8% in US dollar terms in the July and the rouble depreciated by 4.9% against the US dollar. Equities in emerging Europe were marked down 6.0% over the month.

Figure 3: Equity returns in July for Developed Markets, Emerging Markets and Emerging Europe



The instability in the Middle East also remains a concern. The Israel-Gaza flare up has few wider implications given the small size of these economies and the absence of oil, but a return to civil war in Libya has a clear risk to oil supplies, given that Libya's production had been climbing rapidly back to pre-crisis levels of 1.6 million barrels per day. The push in Iraq by Islamic State, formerly known as Islamic State of Iraq and the Levant (ISIS), has stalled as expected as they approach the southern Shia stronghold, but the US was forced to engage when they turned on Kurdish areas in the north of the country.

July reminded the markets that deep underlying financial problems remain in parts of the world. Most notably, one of Portugal's largest banks, Banco Espirito Santo (BES), fell into serious difficulties as its parent group suffered substantial write-offs and a resultant capital shortfall. Although the scale of the required capital injection is modest in comparison to the bailouts of other banks over the past few years, it provides a salutary reminder of the problems that persist in Europe.

The failure of BES could well have been a factor in pushing government bond yields in Europe lower over the month, as the deflationary impact of excessive debt levels continues to weigh on the recovery. Notably, German 10 year government bond yields fell to all-time lows of 1.1%, just below the levels reached during deepest part of the European crisis in July 2012; this compares with a yield of almost 2% at the beginning of this year. Other government bond yields in Europe also fell, in many cases to all-time lows. Economic news from the euro area provided support for lower yields, as the key German economy showed signs of slowing.

The US economy recovered sharply from its weather induced temporary weakness in the first quarter, with a rebound to 4.0% growth in the second quarter of 2014 (and Q1 growth was revised up from -2.9% to -2.1%). This rebound to significant growth, together with continuing strength in jobs growth, pushed up US Treasury yields and led to concerns that the Federal Reserve (Fed) would bring forward the first interest rate rise. Chair of the US Fed, Janet Yellen, remains broadly dovish, however, referring to ample capacity in the US economy. Moreover, the second quarter numbers for growth hide the fact that nearly half of it came from inventory building, suggesting that underlying growth remains at around the 2-2.5% level, consistent with rates staying lower for some time yet.

The Japanese economy is still feeling the effects of the 3.0% sales tax rise in April, but this did not prevent the equity market from continuing its recovery from the sell-off earlier in the year. Of more significance was stabilisation in the Chinese economy, which showed second quarter growth of 7.5%, in line with the full year expectations.

Markets have finally come out of the long period of low volatility and the combination of negative events this month has caused the long awaited setback. This could well continue in the short term, and we would view that as a healthy correction, removing some of the excessive valuations from some assets and sectors. However, the underlying economic news remains supportive and monetary policy will remain loose for some time yet. While we are getting closer to the day when rates will be increased in the US, the rise will be modest and gradual and should come as no surprise to investors.

Source: Bloomberg. Returns in US dollars unless otherwise stated. July 2014.

2. Market performance

		To 31 July 2014		
Asset class/region	Index	Currency	Month	Year to date
Developed markets equities				
United States	S&P 500 NR	USD	-1.4%	5.3%
United Kingdom	MSCI UK NR	GBP	0.0%	1.9%
Continental Europe	MSCI Europe ex UK NR	EUR	-2.7%	3.4%
Japan	Topix TR	JPY	2.1%	0.2% ^e
Asia Pacific (ex Japan)	MSCI AC Asia Pacific ex Japan NR	USD	3.5%	10.8%
Global	MSCI World NR	USD	-1.6%	4.5%
Emerging markets equities				
Emerging Europe	MSCI EM Europe NR	USD	-6.0%	-5.7%
Emerging Asia	MSCI EM Asia NR	USD	3.4%	10.5%
Emerging Latin America	MSCI EM Latin America NR	USD	1.0%	8.3%
BRICs	MSCI BRIC NR	USD	3.2%	8.0%
Global emerging markets	MSCI EM (Emerging Markets) NR	USD	1.9%	8.2%
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	-0.2%	3.1%
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	0.1%	6.5%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	-0.1%	5.6%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	-1.3%	4.1%
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	1.0%	4.6%
UK Corporate (investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	GBP	0.5%	5.2%
Euro Government Bonds	Citigroup EMU GBI TR	EUR	0.9%	8.0%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	0.5%	5.3%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	EUR	-2.6%	1.9%
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	0.2%	1.8%
Australian Government	JP Morgan Australia GBI TR	AUD	0.3%	5.4%
Global Government Bonds	JP Morgan Global GBI	USD	-0.8%	4.2%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	-0.9%	3.8%
Global Convertible Bonds	UBS Global Focus Convertible Bond	USD	-2.0%	3.3%
Emerging Market Bonds	JP Morgan EMBI+ (Hard currency)	USD	0.1%	9.5%

Source: Bloomberg. e denotes estimate

To 31 July 2014				
Asset class/region	Index	Currency	Month	Year to date
Property				
US Property Securities	MSCI US REIT NR	USD	0.0%	17.0%
Australian Property Securities	S&P/ASX 200 A-REIT Index TR	AUD	5.0%	14.0%
Asia Property Securities	S&P Asia Property 40 Index NR	USD	4.8%	6.7%
Global Property Securities	S&P Global Property USD TR	USD	1.1%	12.5%
Currencies				
Euro		USD	-2.2%	-2.6%
UK Pound Sterling		USD	-1.3%	2.0%
Japanese Yen		USD	-1.4%	2.4%
Australian Dollar		USD	-1.5%	4.2%
South African Rand		USD	-0.7%	-1.9%
Commodities & Alternatives				
Commodities	RICI TR	USD	-5.1%	0.2%
Agricultural Commodities	RICI Agriculture TR	USD	-7.3%	-4.1%
Oil	ICE Crude Oil CR	USD	-5.7%	-4.1%
Gold	Gold Spot	USD	-3.4%	6.4%
Hedge funds	HFRX Global Hedge Fund	USD	-0.4% ^e	1.4% ^e
Interest rates			Current rate	Change at meeting
United States	30 July 2014	USD	0.25%	-
United Kingdom	10 July 2014	GBP	0.50%	-
Eurozone	3 July 2014	EUR	0.15%	-
Japan	15 July 2014	JPY	0.10%	-
Australia	1 July 2014	AUD	2.50%	-
South Africa	17 July 2014	ZAR	5.75%	-

^e Estimate

Source: Bloomberg. e denotes 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					
Property (UK)					
Currencies					
GBP					
Euro					
Yen					



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