momentum

Viewpoint

Monthly market update

June 2014

global investment management

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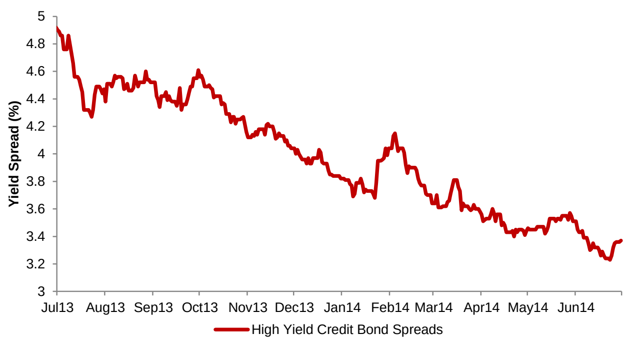
1. Market commentary

Central bank activity continued to dominate markets in what was a strong month for the majority of asset classes. Broadly, equities moved higher in June, led by Japanese stocks which returned 5.3% in yen terms. In the US, the S&P 500 index reached record highs after gaining 2.0% over the month, and emerging markets (EM) equity continued its recovery, returning 2.7% over the month (in US dollar terms). Furthermore, EM debt ended the month up by 0.8% in USD terms, as investor interest in the asset class continued to increase following last year's sharp selloff.

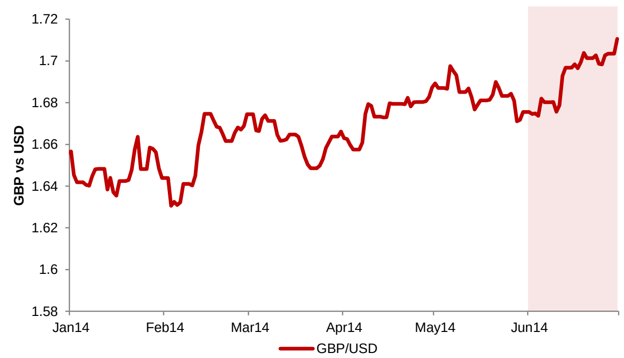
In the face of sluggish growth, the European Central Bank (ECB) loosened policy materially in June. The Bank cut its benchmark interest rate by 0.10%, and took its deposit rate for excess bank returns into negative territory for the first time in its history, to encourage 'active' use of this capital. The ECB has also effectively extended its 'Long Term Refinancing Operation' (LTRO), and re-named it a 'Targeted Long Term Refinancing Operation' (TLTRO). This policy enables banks to borrow money on favourable terms if they pass in on to targeted businesses, namely the credit-starved SMEs of the euro area. In response to concerns over deflation in Europe, and given the continued strength of the euro, ECB President Mario Draghi indicated that further monetary stimulus might be necessary, specifically referring to the appropriateness of "a broad based asset purchase programme" (quantitative easing) for the first time.
In contrast, the US Federal Reserve (Fed) is continuing to taper its asset purchasing programme, now down to USD 35 billion per month and widely expected to go to zero by the end of the year. Janet Yellen, Chair of the Board of Governors at the Fed, remains dovish, although it is noteworthy that she raised concerns about the level of credit spreads, stating that "high yield bonds have caught our attention" (see Figure 1). US GDP growth for Q1 was revised down to -2.9% at an annualised rate, in large part due to the severe winter weather conditions which effectively closed down large chunks of the economy. Since then, data has been pointing to a strong recovery for Q2 and beyond.

Figure 1: High Yield Credit Bond Spreads



In the UK, the Bank of England (BoE) is likely to be the first major central bank to raise interest rates. Governor of the Bank, Mark Carney, has indicated that the first rate hike could come sooner than the market expects, implying a possible hike before the end of the year. When the BoE does raise rates, it will be gradual, and rates are unlikely to return to their pre-crisis highs. Sterling strengthened by 2.1% against the US dollar over the month, and is now up 12.4% versus the greenback over a 12 month period.

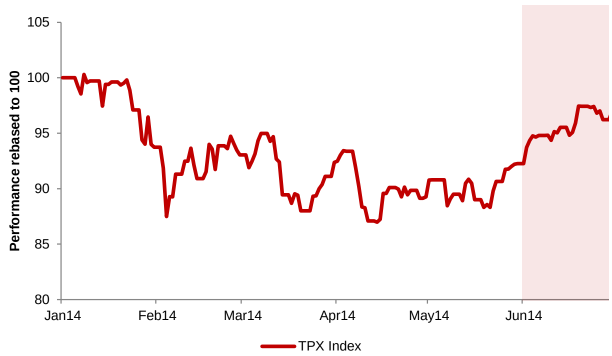
Figure 2. British Pound Sterling vs. US Dollar



The People's Bank of China took steps to ease policy as it lowered banks' reserve requirements. This is part of a series of measures taken in recent months to combat the slowdown in the economy. This is part of a series of steps taken in recent months to combat the slowdown in the economy. The declining growth rate in China seems to have bottomed out, with leading indicators at their highest levels since late last year. Chinese stocks returned 2.7% in June, in US dollar terms, but the problems in credit markets and potential bad debts in the banking system have kept the Chinese stock market subdued, down 4.0% in US dollar terms year-to-date.

Japanese equities recovered strongly in June following a weak start to the year, with valuations having reached particularly attractive levels. Prime Minister Shinzo Abe's 'Third Arrow' reform plans had underwhelmed investors, but there appears to be greater commitment to taking strong action, with an announced cut in corporation tax and other business friendly proposals. In part, the rise in equities also shows a diminished concern around the April increase in sales tax.

Figure 3. Performance of Japan's TOPIX index



Away from central banks, the other dominant feature of the month was geopolitics, especially the rapid advance of the militant Islamic State of Iraq and the Levant (ISIS) in Iraq. This initially caused a surge in the oil price, but as it became clear that resistance was building against ISIS troops as they advanced closer to Shia dominated areas, the price fell back. At the time of writing, ISIS remains someway short of Iraq's southern oil fields, which produce the majority of Iraqi oil. Brent crude ended the month up by 2.7%, still comfortably within its trading range over the past two years. To date, Iraq's oil exports have not been impacted by the ISIS advance, but the situation is clearly unpredictable, and the price of gold reacted with a 5.8% rise over the month.

At this stage of the cycle we remain confident that further upward progress in equity markets can be expected, although not at the same pace as over the past two years when markets were consistently re-valued. We expect yields to rise as the economic recovery in the developed world continues apace and inflation, currently very subdued, begins to build. The extremely low volatility in markets (as implied by the Vix) also suggests a degree of complacency building, and it is important to remember that we are living in unusual times. Interest rates in most developed economies are at or very close to all-time lows, and extraordinary monetary policy is happening on a scale never before seen. Such conditions are likely to result in extraordinary and unpredictable consequences. In our view it is not a time to be reducing risk overall in portfolios but a time to take stock; reduce exposure to those asset classes where valuations have become very stretched and make sure that equity exposure is broadly diversified with a key focus on valuation and quality.

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

2. Market performance

Asset class/region	Index	Currency	Month	Year to date
		To 30 June 2014		
Developed markets equities				
United States	S&P 500 NR	USD	2.0%	6.8%
United Kingdom	MSCI UK NR	GBP	-1.3%	1.9%
Continental Europe	MSCI Europe ex UK NR	EUR	-0.8%	6.3%
Japan	Topix TR	JPY	5.3%	-1.9% e
Asia Pacific (ex Japan)	MSCI AC Asia Pacific ex Japan NR	USD	1.7%	7.1%
Global	MSCI World NR	USD	1.8%	6.2%
Emerging markets equities				
Emerging Europe	MSCI EM Europe NR	USD	2.1%	0.3%
Emerging Asia	MSCI EM Asia NR	USD	2.8%	6.9%
Emerging Latin America	MSCI EM Latin America NR	USD	4.1%	7.2%
BRICs	MSCI BRIC NR	USD	4.2%	4.7%
Global emerging markets	MSCI EM (Emerging Markets) NR	USD	2.7%	6.1%
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	-0.2%	3.3%
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	0.3%	6.4%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	0.1%	5.7%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	0.8%	5.5%
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	-0.6%	3.5%
UK Corporate (investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	GBP	-0.2%	4.7%
Euro Government Bonds	Citigroup EMU GBI TR	EUR	1.1%	7.0%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	0.6%	4.8%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	EUR	0.9%	4.7%
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	0.3%	1.6%
Australian Government	JP Morgan Australia GBI TR	AUD	1.0%	5.0%
Global Government Bonds	JP Morgan Global GBI	USD	0.7%	5.0%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	0.7%	4.8%
Global Convertible Bonds	UBS Global Focus Convertible Bond	USD	0.5%	5.4%
Emerging Market Bonds	JP Morgan EMBI+ (Hard currency)	USD	0.8%	9.5%

Source: Bloomberg. e denotes estimate

Asset class/region	Index	Currency	Month	Year to date
		To 30 June 2014		
Property				
US Property Securities	MSCI US REIT NR	USD	1.0%	17.0%
Australian Property Securities	S&P/ASX 200 A-REIT Index TR	AUD	0.6%	8.6%
Asia Property Securities	S&P Asia Property 40 Index NR	USD	0.6%	1.9%
Global Property Securities	S&P Global Property USD TR	USD	1.4%	11.3%
Currencies				
Euro		USD	0.4%	-0.4%
UK Pound Sterling		USD	2.1%	3.3%
Japanese Yen		USD	0.4%	3.9%
Australian Dollar		USD	1.3%	5.8%
South African Rand		USD	-0.6%	-1.2%
Commodities & Alternatives				
Commodities	RICI TR	USD	1.2%	5.5%
Agricultural Commodities	RICI Agriculture TR	USD	-3.2%	3.5%
Oil	ICE Crude Oil CR	USD	2.8%	1.7%
Gold	Gold Spot	USD	6.2%	10.1%
Hedge funds	HFRX Global Hedge Fund	USD	0.8% e	1.6% e
Interest rates			**Current rate**	**Change at meeting**
United States	18 June 2014	USD	0.25%	-
United Kingdom	5 June 2014	GBP	0.50%	-
Eurozone	5 June 2014	EUR	0.15%	-
Japan	16 June 2014	JPY	0.10%	-
Australia	1 July 2014	AUD	2.50%	-
South Africa	22 May 2014	ZAR	5.50%	-

Source: Bloomberg. e denotes estimate

3. Asset allocation dashboard

Positive	Neutral	Negative

Asset class	View
Equities	
Developed equities	Neutral
UK equities (relative to developed)	Neutral
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)	Neutral
High yield	Negative
Loans	Positive
Emerging market debt	Positive
Convertible bonds	Neutral
Alternatives	
Commodities	Neutral
Property (UK)	Neutral
Currencies	
GBP	Neutral
Euro	Neutral
Yen	Negative

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