momentum

Viewpoint

Monthly market update

October 2014

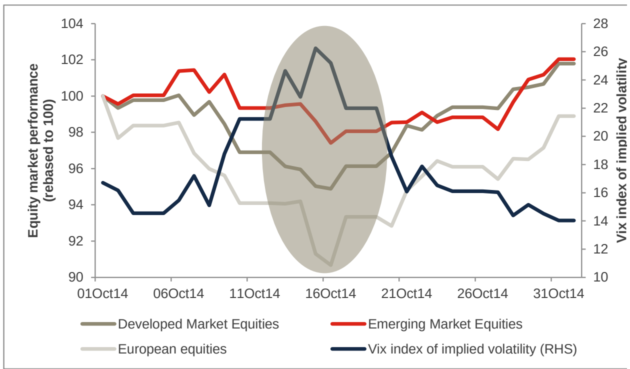
global investment management

Contents

1. Market commentary

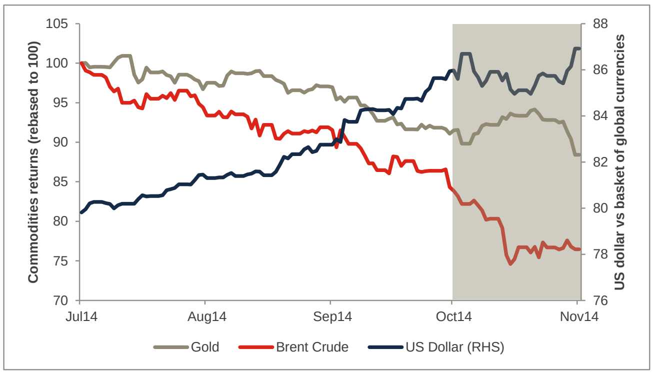
October saw volatility return to markets, with the Vix index of implied volatility reaching levels not seen since the euro crisis in 2012. Equities fell sharply in the first half of the month, but rallied equally dramatically, with the result that developed market equities ended the month up by 0.6% while emerging market equities added 1.2%. This resurgence was led by the S&P 500 which rose by 2.4% over the month. Europe underperformed, finishing the month down by 2.0% in euro terms despite also seeing a strong rally in the second half of the month.

Figure 1: Volatility spikes as markets fall at the start of October



As equity markets sold off, government bond yields fell sharply in the first half of October, with the yield on 10-year US Treasuries falling to circa 1.8% on 15 October. Yields subsequently recovered but are still some 15 basis points (0.15%) lower over the month. Government bonds produced reasonable returns, with US Treasuries adding 1.1%, while the US dollar strengthened against a basket of major currencies. Dollar strength weighed on the price of gold, which dipped below its key support level of USD 1,200 per troy ounce. The price of Brent crude oil also continues to slide from its June peak, reaching USD 85 a barrel in October, its lowest level for over four years. Oil prices fell by 10.6% in October and have now fallen by close to 30% since mid-June. This has come on the back of weak global demand; a price cut by Saudi Arabia and increased US output.

Figure 2: Commodity prices continue to fall as the US dollar strengthens



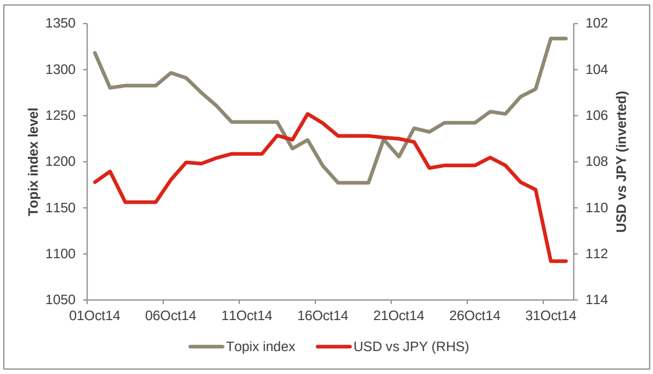
There are two big themes driving markets currently. First, global growth is slowing. In particular, the euro area continues to disappoint. Industrial production in Germany fell by 4.0% month-on-month, exports fell by 5.8% month-on-month and the ZEW economic confidence indicator also dropped in October (-3.6%). Weak growth was reflected in falling inflation across the euro area, with several countries – including France and Spain – experiencing outright deflation. The European Commission lowered its euro area growth forecast for 2014 to 0.8% compared with 1.2% six months ago, and lowered its 2015 estimate from 1.7% to 1.1%.

Besides Europe, China is also struggling to maintain growth rates. Third quarter GDP growth slowed to 7.3% compared with the government's target of 7.5%. Excessive debt, over-capacity and falling property prices are all weighing on growth, which looks set to fall further in the year ahead. In contrast, the US and UK, are both growing at over 3% currently (US third quarter GDP estimates came in at 3.5%).

The second key theme of the month was the divergence of central bank policy. While the Federal Reserve (Fed) brought its asset purchase programme to an end last month, the European Central Bank (ECB) began buying covered bonds in an attempt to ease pressure on banks and release liquidity into the markets. Mario Draghi, President of the European Central Bank (ECB), said that the bank is willing to implement "further measures if needed", while reiterating the bank's commitment to expanding its balance sheet by EUR 1 trillion. October saw the publications of the ECB's Asset Quality Review and the results of the banking 'stress tests', which were designed to bring renewed confidence to the banking sector. Thirteen banks fell short of the ECB's requirements, based on data from the end of 2013. Many of these institutions have raised capital since then. Although the results were broadly welcomed by the market, investors questioned the robustness and severity of the stress tests which had no deflationary scenario built in.

The big surprise was the action at the end of the month by the Bank of Japan, which increased its asset purchase programme from JPY 60-70 trillion per annum to JPY 80 trillion, nearly matching the quantitative easing programme of the Fed at its peak. As well as buying bonds, the Bank of Japan is also set to increase its purchases of equity Exchange Traded Funds (ETFs) to JPY 3 trillion per annum (USD 27 billion). The reaction in markets was immediate and dramatic, with the yen falling to a 7-year low, pushing the equity market up by 5.0% in yen terms in two days.

Figure 3: Japan's Topix index versus the Japanese yen



Fragile growth and deflationary forces globally; divergent central bank policies and a high debt overhang and asset values which in most cases are no longer intrinsically cheap (and often expensive) are likely to result in further periods of volatility such as the one we have just seen in October. It is clear, however, that central banks are ready to take action to ensure stability. The prospect of this support is in turn expected to provide support for markets.

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

2. Market performance

Asset class/region	Index	To 31 October 2014		
		Currency	Month	Year to date
Developed markets equities				
United States	S&P 500 NR	USD	2.4%	10.4%
United Kingdom	MSCI UK NR	GBP	-1.0%	-0.1%
Continental Europe	MSCI Europe ex UK NR	EUR	-2.0%	4.5%
Japan	Topix TR	JPY	0.6%	4.3%
Asia Pacific (ex Japan)	MSCI AC Asia Pacific ex Japan NR	USD	2.7%	6.4%
Global	MSCI World NR	USD	0.6%	4.6%
Emerging markets equities				
Emerging Europe	MSCI EM Europe NR	USD	-1.4%	-13.3%
Emerging Asia	MSCI EM Asia NR	USD	1.5%	6.7%
Emerging Latin America	MSCI EM Latin America NR	USD	-0.1%	1.2%
BRICs	MSCI BRIC NR	USD	2.6%	3.9%
Global emerging markets	MSCI EM (Emerging Markets) NR	USD	1.2%	3.6%
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	1.1%	4.8%
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	1.0%	5.2%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	1.0%	6.7%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	1.2%	4.7%
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	1.4%	9.0%
UK Corporate (investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	GBP	0.8%	8.5%
Euro Government Bonds	Citigroup EMU GBI TR	EUR	0.3%	10.4%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	0.4%	7.2%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	EUR	-0.7%	-4.7%
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	0.5%	2.8%
Australian Government	JP Morgan Australia GBI TR	AUD	1.3%	7.5%
Global Government Bonds	JP Morgan Global GBI	USD	-0.1%	1.5%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	0.1%	1.7%
Global Convertible Bonds	UBS Global Focus Convertible Bond	USD	0.4%	-0.2%
Emerging Market Bonds	JP Morgan EMBI+ (Hard currency)	USD	2.1%	9.4%

Source: Bloomberg. e denotes estimate

		To 31 October 2014		
Asset class/region	Index	Currency	Month	Year to date
Property				
US Property Securities	MSCI US REIT NR	USD	9.9%	24.3%
Australian Property Securities	S&P/ASX 200 A-REIT Index TR	AUD	6.8%	17.1%
Asia Property Securities	S&P Asia Property 40 Index NR	USD	4.4%	2.5%
Global Property Securities	S&P Global Property USD TR	USD	5.7%	12.8%
Currencies				
Euro		USD	-0.8%	-8.9%
UK Pound Sterling		USD	-1.3%	-3.4%
Japanese Yen		USD	-2.4%	-6.3%
Australian Dollar		USD	0.6%	-1.3%
South African Rand		USD	2.2%	-4.8%
Commodities & Alternatives				
Commodities	RICI TR	USD	-1.7%	-8.9%
Agricultural Commodities	RICI Agriculture TR	USD	7.1%	-6.0%
Oil	ICE Crude Oil CR	USD	-10.6%	-22.7%
Gold	Gold Spot	USD	-2.9%	-2.7%
Hedge funds	HFRX Global Hedge Fund	USD	-1.7% [e]	-0.5% [e]
Interest rates			**Current rate**	**Change at meeting**
United States	29 October 2014	USD	0.25%	-
United Kingdom	9 October 2014	GBP	0.50%	-
Eurozone	2 October 2014	EUR	0.05%	-
Japan	31 October 2014	JPY	0.10%	-
Australia	7 October 2014	AUD	2.50%	-
South Africa	18 September 2014	ZAR	5.75%	-

[e] Estimate

Source: Bloomberg. e denotes estimate

3. Asset allocation dashboard

Positive	Neutral	Negative

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

For more information, please contact:

Russell Andrews
Head of Distribution Services
E: Russell.andrews@momentumgim.com
T: +44 (0)207 618 1803

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