capital markets service

Quarterly update July 2013

Be careful what you wish for

Graeme Johnston

Investors have been confronting the consequences of the economic recovery that most have been hoping for. That emergency monetary measures would not be required once the emergency was over should perhaps have been no surprise. The Fed's intimation that QE may be coming to an end still proved very disruptive at the end of the second quarter.

Subsequent reassurance from the Fed helped global equity indices to recoup most of a 6% setback in short order, but government bond yields have been less easily assuaged. 10-year US and UK yields remain close to their highest levels since summer 2011. Central bankers have been consistent in their message that policy will be driven by economic conditions. In recent months there have been some encouraging signs for the global economy, but also reminders that the recovery remains fragile. The end of QE is by no means a done deal.

"… there have been some encouraging signs for the global economy, but also reminders that the recovery remains fragile."

Government bonds (p3)

Real yields may have risen a little, but only to levels that would have marked all-time lows at any point before this year. Valuations are tolerable only for those who require the security and cast-iron guarantee against inflation that they offer. The cost of inflation protection is reasonable at shorter maturities (say out to 10 years or so), but becomes increasingly expensive at longer maturities.

Conventional yields, too, are higher than they were a few months ago, but still very low on a longer perspective. The implied increase of interest rates over the next 10 years still seems slow and we think yields, particularly at shorter maturities, have further to rise.

Equities (p5)

For investors more concerned about long-term income and income growth than short-term price fluctuations, equities still offer the prospect of good returns relative to risk-free assets. In absolute terms, valuations do not, in our view, have a sufficient cushion to absorb higher risk-free yields or a downturn in profits and we therefore think that further setbacks are likely.

Credit markets (p4)

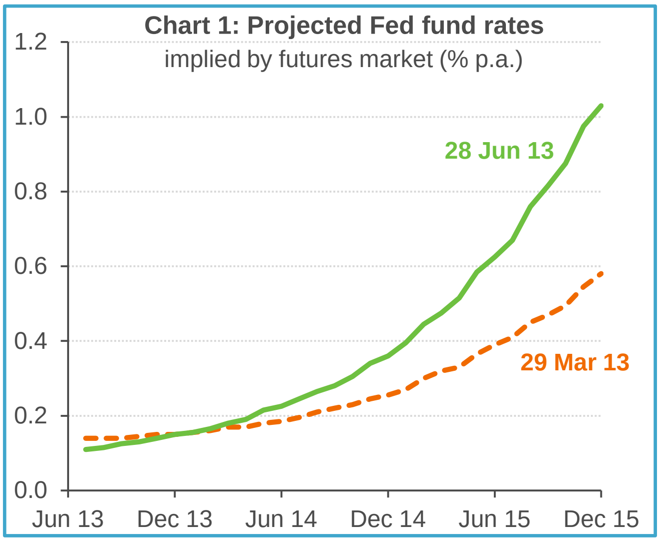
Sterling investment grade bonds are not extremely expensive relative to gilts, but we still think it would be optimistic to expect further sustained outperformance driven by reductions in yield margins. Where it suits for strategic purposes, investors may be content to collect the extra income over the long term.

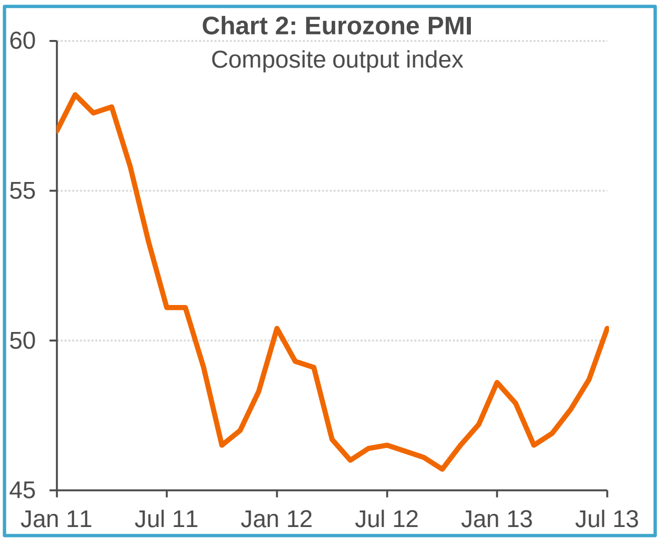
Absolute valuations in higher-yielding markets, such as emerging market debt and secured loans, are by no means cheap. These markets have attractions as a strategic diversification from equities rather than as tactical opportunities. Indicative yields in private debt markets continue to offer better value.

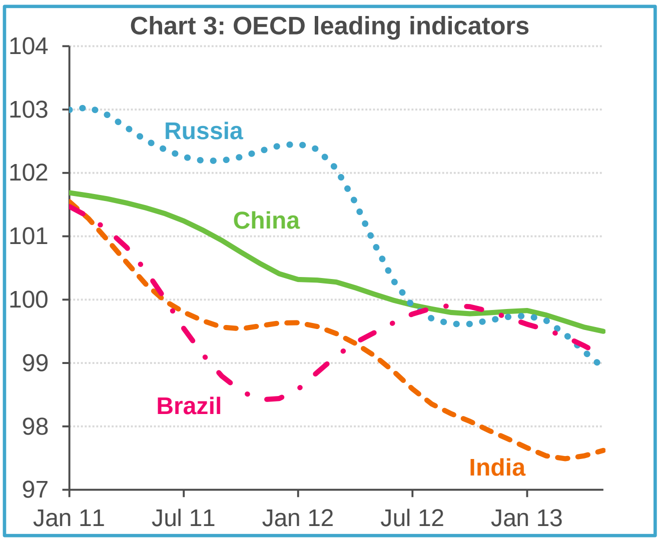
Property (p6)

Long-term investors more interested in the flow of income than the movement in capital values should be using the relatively poor performance since summer 2011 to top up exposure. But we would not want to be above target. As with equities, we do not think valuations are sufficiently cheap to cope with rising risk-free yields or to compensate for what remains a difficult fundamental outlook.

MARKET BACKGROUND







Much ado

If the end of QE is worth discussing, one of the big economic risks of last year – US fiscal tightening – clearly does not loom large. Soft GDP growth is forecast for Q2 13, but is seen by most commentators as a blip in a recovery, which nevertheless remains modest. Unemployment has hardly fallen this year and remains well above the 7% level at which many think the Fed might bring its QE programme to an end. Core inflation of 1.6% p.a. is no impediment to further monetary easing if required. The Fed should be believed when it insists it will be flexible about the pace of QE in both directions. It is easy to overlook the modest scale of any recent economic reassessment – the difference between official US interest rates of 0.5% p.a. or 1% p.a. in two-and-a half years' time (chart 1) is a rounding error. The path to significantly higher rates could easily bring more of the disruption that affected markets at the end of Q2.

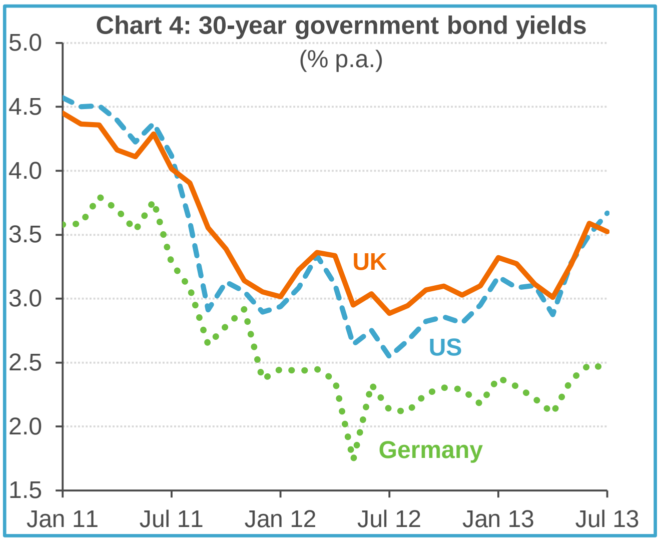
Stable (but still critical)

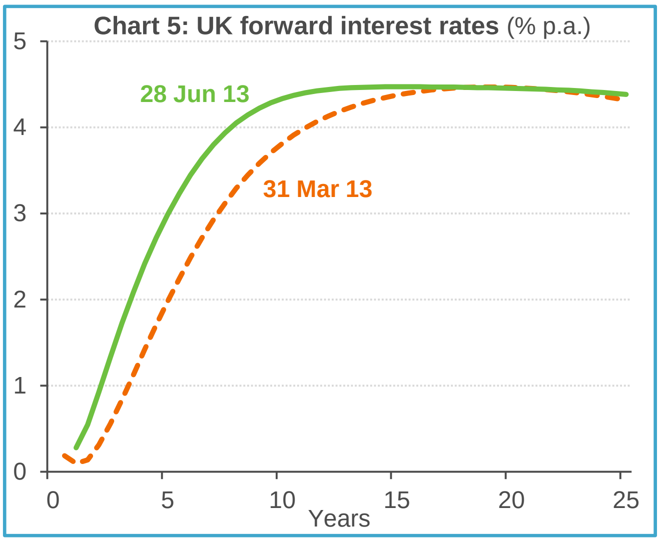
The picture in the other major developed economies has also been fairly bright in recent months. Japan appears to have retained economic momentum from the start of the year. The UK has seen a second successive quarter of economic growth. As expected, vested political interests extrapolated this enthusiastically, but even the Bank of England acknowledged the possibility of a strong second half to the year when leaving policy unchanged at its last meeting. Perhaps most surprisingly, there are signs that the Eurozone may have passed the worst. The PMI Composite Output index (based on survey evidence from manufacturing and service companies) has edged above the key 50 level for the first time in 18 months (chart 2). However, a political crisis in Portugal provided a reminder that the Eurozone economy still represents a very real risk.

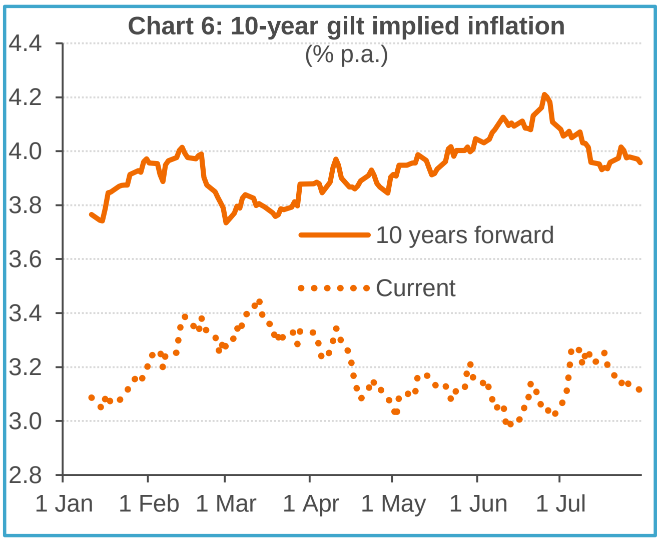
Growing pains

The news is less good in the major developing economies. Chart 3 shows OECD leading indicators (an often useful guide to the outlook for industrial production) for the BRIC countries. These have been drifting down and all now lie below the 100 level that, in broad terms, marks the division between above- and below-trend growth. These statistics cannot tell the whole story about any economy, but they do chime with more general concerns about the economic outlook. Weak commodity prices have a significant effect on Brazil and Russia; India is seen as needing to undertake some significant structural reforms; concerns are resurfacing about the disruptive impact of a shift to consumption-led growth in China. We have certainly been careful not to get carried away with enthusiasm about all things emerging, but investors should not let cyclical weakness completely obscure genuine secular strengths.

GOVERNMENT BONDS







Insurance evaluation

Fed comments on QE caused a dramatic rise in 30-year US Treasury Bond yields in May and June but, as chart 4 suggests, it was hardly out of line with the general upward drift of the last year. If the short-term reaction verged on the incontinent, it would be tendentious to claim it as the initial panic in the bursting of a bond bubble. The 12 month trend can be seen as a measured response to modest economic improvement. Smaller rises in equivalent UK and German yields partly reflect the global nature of bond markets but, here too, domestic economic conditions seem less gloomy than they did in the middle of last year. Yields are still low by historic standards and the investment case for bonds is far from compelling. But bonds are as cheap as they have been for some time and should not be overlooked as insurance against persistent economic risks.

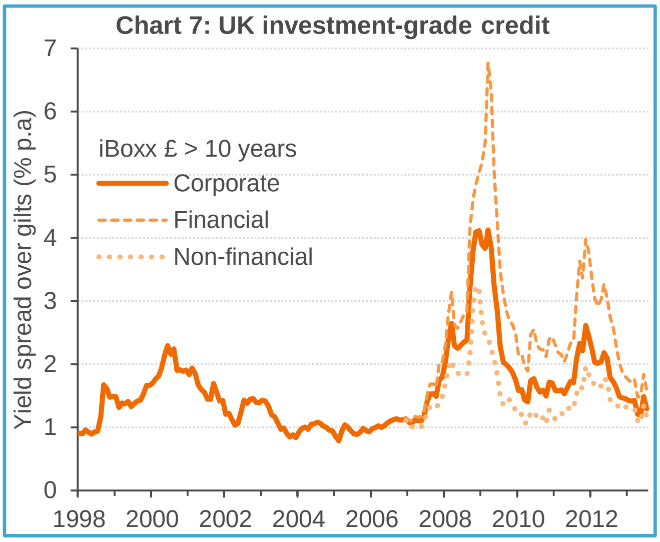
Slow progress

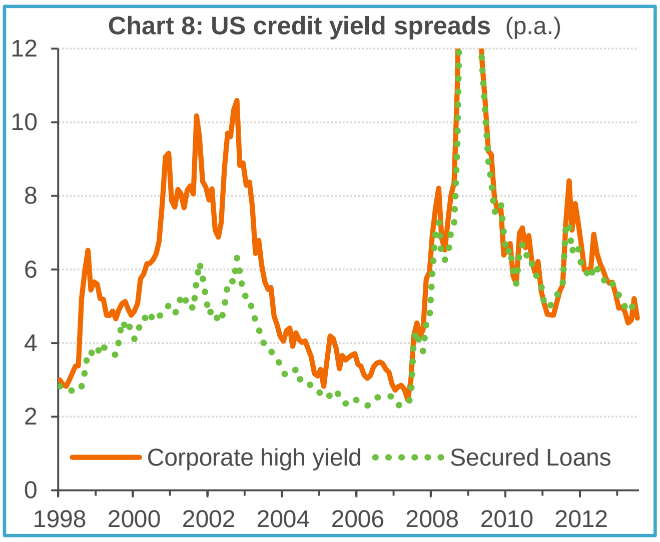
We have used forward interest rates in the past to illustrate the return to more normal conditions (in this context, interest rates of around 4.5% p.a.) implied by the gilt market. As has been the case for the last few years, the latest move in gilt yields reflected a change in the speed at which normality is restored rather than the eventual level of interest rates (chart 5). Forward starting rates are 4% p.a. or higher from about 8 years onwards, offering more reasonable hedging opportunities for those willing to implement on a piecemeal basis. For those who take a more straightforward approach, relative performance means that now is the best time in almost two years to sell equities to increase long-dated interest rate hedges. Even if gilt yields have further to rise – and 8 years still seems a long time for interest rates to normalise – pension schemes should be considering whether this is an opportunity to reduce risk.

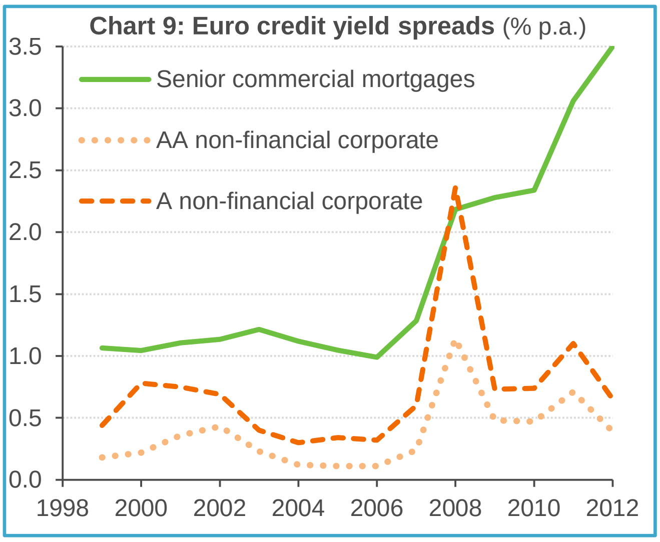
Limited opportunities

We highlighted an anomaly in the price of inflation hedging last month (*Selective immunisation*, p2). An overall rise in long-dated inflation swap prices concealed a fall in 10-year implied inflation and a steeper rise in implied inflation covering the period from year 10 onwards. A convincing economic explanation was hard to find. It is no great surprise, therefore that the divergence has been reversed a little since late June, as can be seen from chart 6, which shows two versions of 10-year implied inflation – starting now and starting in 10 years' time. The current cost of 10-year inflation protection is no better than average by the standards of recent years (albeit still more reasonably priced than forward starting protection). The opportunity to hedge inflation at levels close to 3% p.a. was short-lived, but it illustrates the importance of planning and monitoring for those looking to implement hedging strategies flexibly.

CREDIT







Most liquid

Credit markets wobbled in May and June as investors contemplated the possible end of QE in the US. They have rallied more recently along with other risk assets. As chart 7 suggests, on any long-term perspective, the impact on yield spreads in investment grade markets was modest. Spreads on corporate bonds are in the middle of their “normal” range (i.e. excluding the credit crunch) and the divergence between financial and non-financial issues that opened up during the credit crunch is now as low as it has been for almost 5 years. Where investment-grade credit is fulfilling a strategic role – boosting return in a low-risk portfolio or matching cash flows – then a neutral allocation looks about right. Other parts of the credit universe look more interesting from an investment perspective, although valuations in non-investment-grade markets are also as demanding as they have been for many years.

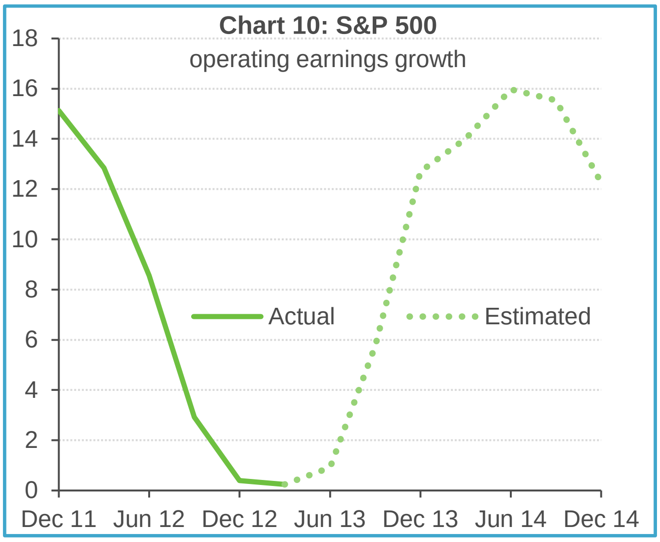
Less liquid

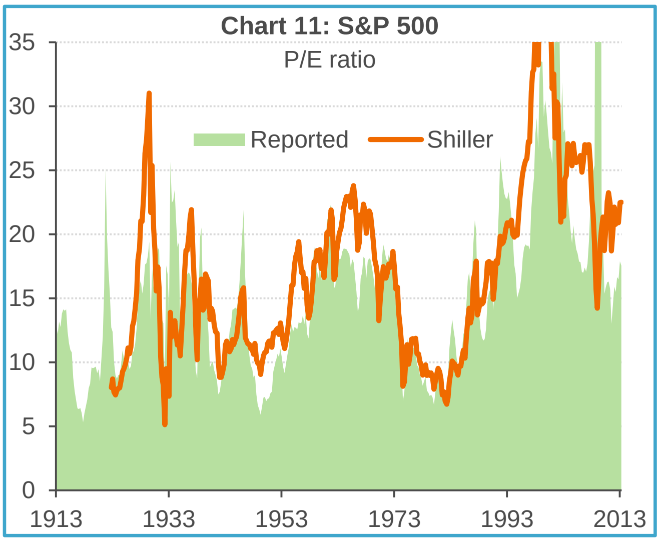
We believe the strategic argument for diversification into credit still holds good where investment is being made out of equity exposure. Chart 8 shows spreads in the most widely traded non-investment grade markets – US high yield bonds and secured loans. The convergence of yield spreads in the two markets is somewhat surprising, although there is a growing overlap of issuers in the market. But the earlier position – a lower yield spread on secured loans – is perhaps easier to rationalise. On average, the rate of defaults in the two markets is similar but recovery rates in the event of default have been significantly higher for secured loans. Of course, individual stock selection is important but, in a period when default experience has been benign, investors may be underpricing the security of loans and overpaying for the higher liquidity of bonds.

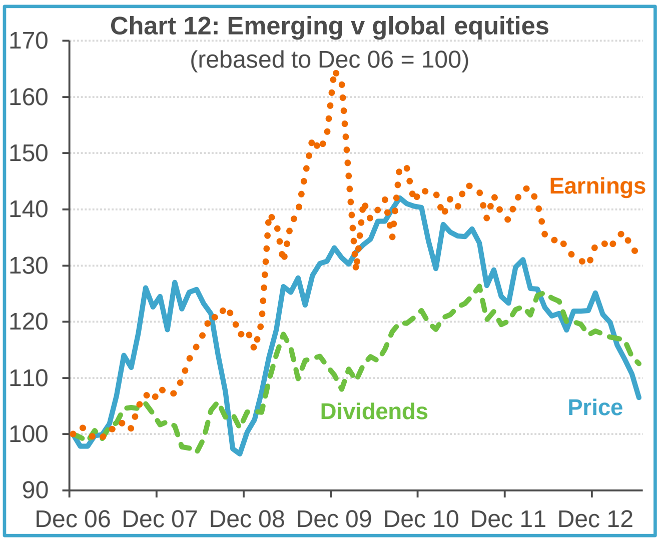
Illiquid

The persistence of illiquidity premiums is more obvious in private debt markets that were dominated by banks in the boom years of 2000s. Areas such as real estate debt, infrastructure debt and direct corporate lending are still struggling to attract capital from alternative sources. Chart 9 shows indicative yield spreads on euro-denominated commercial mortgages, which have tended to rise in the last few years even as spreads in public credit markets have narrowed sharply. The chart uses high quality corporate bonds as an appropriate comparison in recognition of the strength of the security of senior mortgages. Typically, property values would have to fall by over 30% before any loss would be incurred. Broad credit allocations will often be easier to manage with a tradable core, but private markets are certainly worth exploring for those who can tolerate the illiquidity.

EQUITIES







Bad news bulls

As usual, US earnings for the quarter just ended are beating expectations; as usual, expectations had fallen substantially in advance. Even the sceptical would have to note that this year's numbers mark an improvement on the subdued finish to 2012. The quarterly momentum has not yet translated into annual growth in the trailing twelve-month numbers shown in chart 10; we have to wonder whether it will ever be sufficient to achieve the heady level of growth forecast for next year. This is well in advance of any likely growth in sales and therefore requires profit margins to move beyond current near-record highs. While short-term momentum may be enough to underpin equities for the moment, it was perhaps significant that equities reacted negatively in June to the prospect of the economy being weaned off QE and recovered only when it was emphasised that emergency support would remain in place for some considerable time.

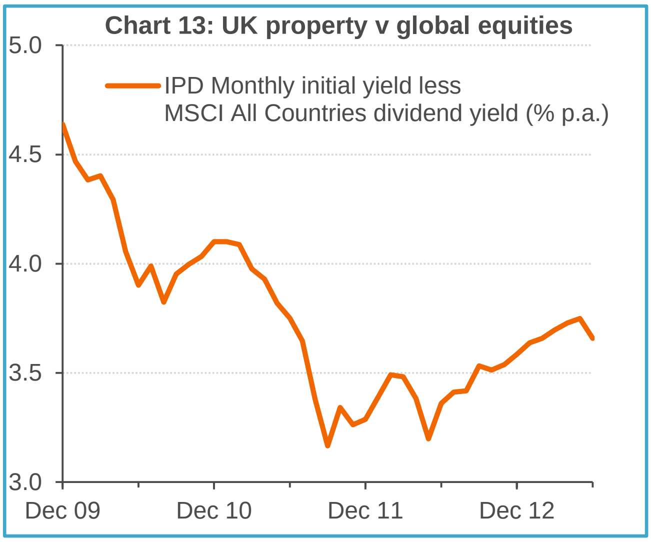
Valuation strains

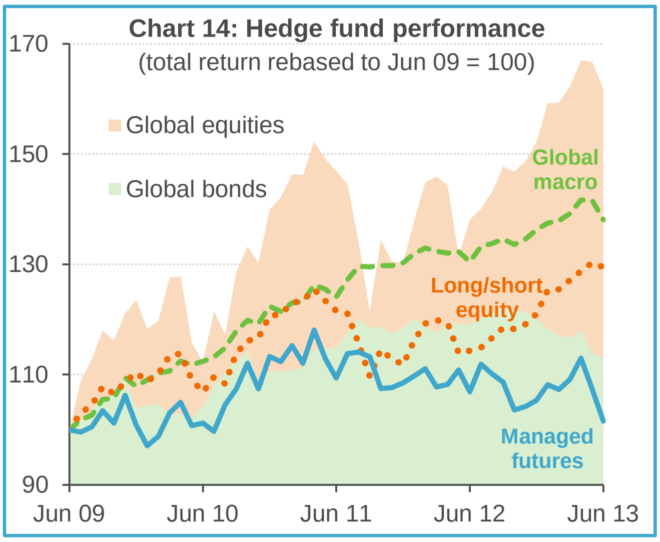
Short-term momentum in markets (in either direction) is reflected in revaluation, which is often a powerful influence on returns over periods of years. This is why we are cautious on US equities in particular. Just as revaluation has driven a 50% rally since Q4 2011 despite lacklustre earnings growth, a reversal could offset the effect of strengthening in earnings growth in the immediate future. Chart 11 shows the price earnings ratio on US equities over the last century. On the basis of reported earnings over the previous 12 months, valuation is towards the upper end of historic ranges; the Shiller ratio, which uses 'trend' earnings averaged over 10 years looks even more stretched. If stronger earnings means a stronger economy and, eventually, higher interest rates and higher bond yields, then it may be optimistic to expect much or even any positive contribution to returns from further revaluation.

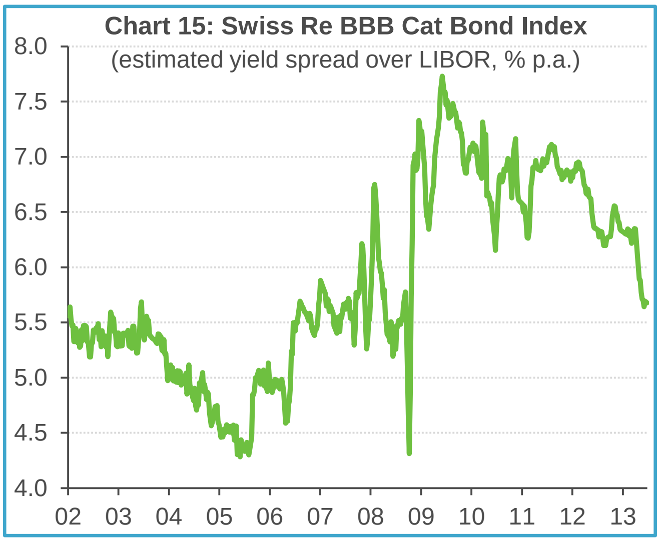
An emerging opportunity

Given its dominance, it is difficult to be negative on the US and positive on global equities in aggregate. However, valuations are not so stretched everywhere (even if the profits outlook may be duller). Chart 12 shows the relative performance of MSCI's emerging market (EM) index relative to its global index. The EM index has underperformed by around 25% from a peak in 2009. On various valuation bases, the emerging market index is relatively cheap. That conceals as much as it reveals; underlying the aggregates, there are expensive individual emerging markets and cheap individual developed markets. We prefer not to invest in emerging markets as a block. However, just as it was wrong to get too enthusiastic four years ago, now is not the time to run for cover. Where emerging markets have a fixed strategic allocation, clients should be topping up exposure.

OTHER INVESTMENTS







Capital preservation

The IPD UK Monthly capital value index edged higher in May and June for the first time since October 2011, providing some confirmation of anecdotal evidence of renewed institutional interest in UK commercial property, which has underperformed global equities by over 30% in four years. Valuation provides some support: the extra yield on property relative to equities has increased since late 2011 (chart 13), but not back to the levels of late 2009. Rents have fallen since then while equity dividends have boomed. Of course, the equity dividend boom will not last forever, but substantial strength in property rents still seems a distant prospect while void levels are so high. Taking advantage of underperformance to top up property exposure makes a great deal of sense – clients should be ready to take profits from above-target equity exposure. In absolute terms, however, property does not look particularly cheap.

Waiting for the fall

Hedge funds, as a group, lost their aura of invincibility in the ruins of Lehman Brothers and recent performance (chart 14) has threatened to undermine any remaining mystique. To an extent this is unfair – diversifying assets cannot be expected to hold their own in an equity bull market. We do wonder, however, whether equity long-short funds are much more than a high-cost and diluted version of the equity market. We have been more open to the merits of those sectors that continue to show lower correlation with equities. The recent picture is mixed: on the basis of the Credit Suisse indices shown, Global Macro has done well, but absolute returns from Managed Futures have been too low. This is affected by the constituent funds: comparable indices from other providers show better (though not good) performance from Managed Futures. In any case, the real test will come if and when equity markets falter in earnest.

Uneconomic investments

Insurance-linked securities (ILS) performed well from late 2012 through April 2013, but have fallen back over the last couple of months. Any similarity to the pattern of performance of other risk assets is coincidental – ILS still provide diversification at a fundamental level. Their earlier strength was a recovery from setbacks caused by Superstorm Sandy, not a reflection of growing economic optimism. Hurricanes in Oklahoma and floods in Europe are a more likely cause of recent weakness than tapering of QE. But a sound strategic case needs to be matched by a sensible implementation price. Investor demand has continued to push down ILS risk premiums (chart 15), but we still think that valuations remain reasonable, whether compared to other risk premiums or to their own history. Any plans to diversify into ILS need not be put on hold yet.

MARKET RETURNS (%)				Local currency		Sterling	
UK	Q2 2013	H1 2013	**OVERSEAS**	Q2 2013	H1 2013	Q2 2013	H1 2013
EQUITIES	-1.7	8.5	**EQUITIES**				
BONDS			North America	2.4	12.7	2.2	20.3
Conventional gilts	-3.8	-3.1	Europe ex UK	0.6	6.2	1.2	11.4
Index-linked gilts	-6.5	0.8	Japan	10.3	33.6	4.5	24.7
Credit	-2.9	-1.3	Developed Asia ex Japan	-4.0	0.3	-10.3	-0.6
PROPERTY	1.9	2.9	Emerging Markets	-3.8	-4.6	-7.5	-2.5
STERLING			**GOVERNMENT BONDS**	-1.7	-1.0	-3.0	1.0
v US dollar	-0.1	-6.7	**HEDGE FUNDS ****	0.1	3.7		
v Euro	-1.3	-5.4	**COMMODITIES ****	-8.4	-9.6		
v Japanese yen	5.5	7.2	*** Local currency = $*				

SOURCES

CHARTS

Babson Capital, Bank of England, Bloomberg, Credit Suisse, Datastream, Hymans Robertson, IPD, M&G , Standard & Poor's

TABLE

Datastream – indices as shown below

Equities	
UK	FTSE All-Share
Overseas (developed)	FTSE World
Emerging Markets	FTSE All-World
Bonds	
Conventional gilts	FTSE-A UK Gilts All Stocks
Index-linked gilts	FTSE-A UK Index Linked Gilts All Stocks
UK credit	iBoxx Non Gilts All Maturities
Government	JP Morgan Global
Property	IPD Monthly
Hedge Funds	Dow Jones Credit Suisse Hedge Fund
Commodities	S&P GSCI Light Energy

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