HYMANS ROBERTSON
The Spirit of Independence

capital markets service

Quarterly update Q2 2014

Flying so high

Graeme Johnston

Economic optimism has waned a little since the end of 2013, but there has been little sustained effect on financial markets: valuations have generally become more demanding in 2014. Many commentators (not all wholly disinterested) would emphasise an absence of bubbles in markets and, while valuations may be stretched, they are not at historic extremes. However, records don't have to be broken before corrections are triggered and, even if valuations adjust gradually, prospective returns could be disappointing.

It might be time to look again at the merits of cash. Yes, returns are likely to remain very low for some time and it is absolutely not a strategically suitable asset for pension schemes. However, it can have a part to play in their short- to medium-term risk management frameworks. Those schemes with flexibility to hold some cash should be doing so.

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> … it is difficult to find any part of the yield curve that does not look expensive
>
> Our problem with equities is that we can't work out what will sustain future returns."

Government bonds (p3)

A modest fall in conventional gilt yields in 2014, coupled with the resilience of equities, means that the terms for de-risking are still close to the best of recent years. At a more detailed level, it is difficult to find any part of the yield curve that does not look expensive, although if your view is that interest rates will normalise very slowly, there may be opportunities to hedge at shorter maturities.

Real yields have dropped a little, too, and hedging here is even more a transaction of necessity rather than choice. It is nevertheless important to recognise necessity where it exists and design programmes to exploit plausible opportunities and not remain exposed to unwanted levels of risk by waiting for an unlikely return to historic norms.

Credit markets (p4)

As yield margins have continued to compress, there is an increasing likelihood that they are unsustainably low. A rising risk of correction is common to many markets, so even if the tactical outlook for credit is unsettled, it can continue to fulfil a strategic role. It is important to be clear what the role is: the wrong response to lower yields is to raise risk simply to maintain a fixed target.

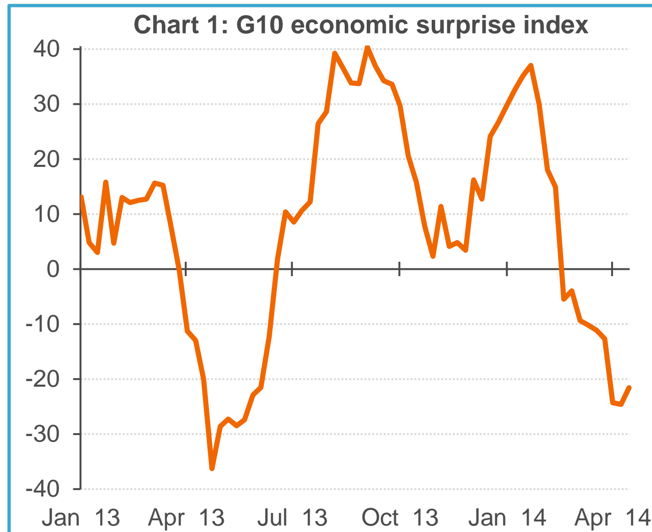
Equities (p5)

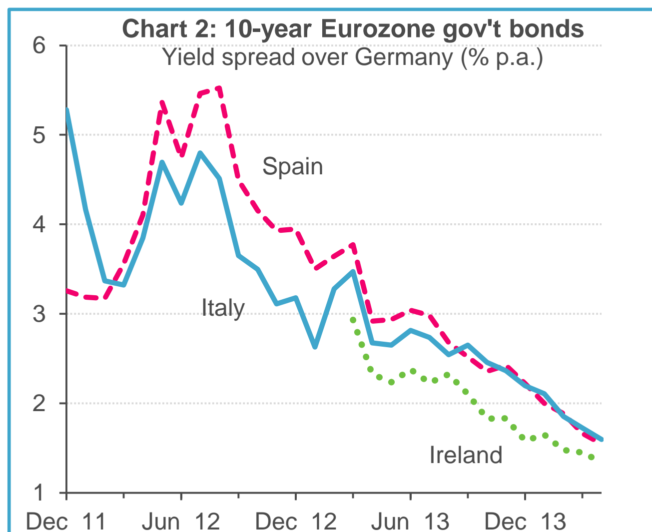
Our problem with equities is that we can't work out what will sustain future returns. Valuations have become much more demanding since the last serious setback in summer 2011, by no means in bubble territory, but likely to face a stiffer comparison with higher risk-free rates as economies normalise. Of course, a failure of economies to normalise would call into question the outlook for earnings growth. And while some markets have still to see a cyclical recovery in earnings, US equity earnings have already passed previous peaks.

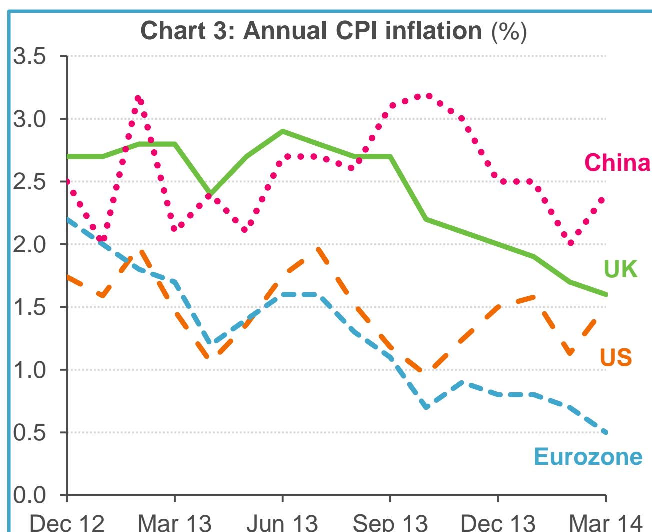
Property (p6)

As capital values continue to push higher in the absence of rental growth, yields have fallen to their lowest levels in over five years. Valuations do not look particularly stretched relative to other assets, but illiquidity and dealing costs are considerations. Pushing on with strategic plans to reduce exposure makes more sense than scrabbling to close small shortfalls from target.

MARKET BACKGROUND







Unsurprised

Data have played their part in a waning of global economic optimism so far in 2014. (The UK is an exception.) A stalling of the US economy in the first quarter was clear long before the release of flat GDP numbers; PMI surveys in Japan fell sharply. However, the elevated level of optimism at the end of last year was perhaps a more important factor. Chart 1 shows the Citigroup economic surprise indicator for the G10 economies (most of North America, Japan and Western Europe). It shows to what extent data releases are beating (>0) or falling short (<0) of forecasts. The scale of the swing in recent months is evident. Market resilience is perhaps understandable – leading indicators still signal expansion; most forecasts suggest higher global growth in 2014 than in 2013. But, as markets climb higher, the margin for disappointment looks very thin.

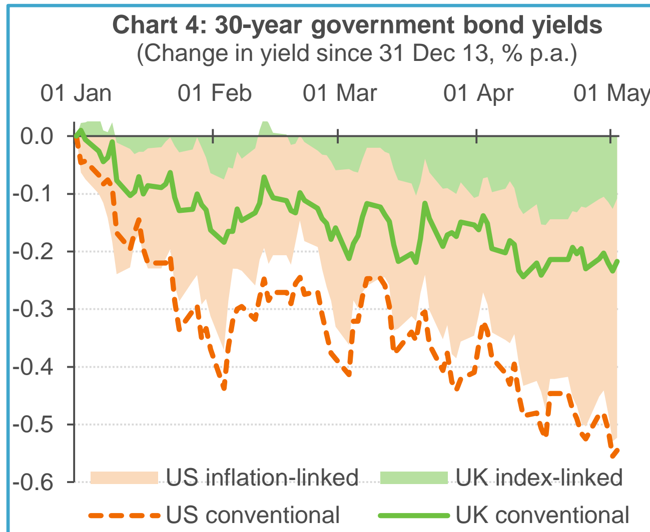
Forgotten but not gone

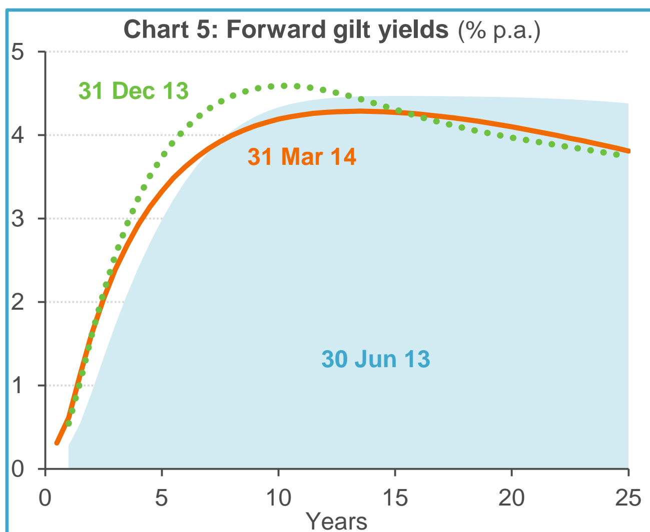
If a dose of realism has been injected into investors' overall expectations for the global economy, the more extreme risks are apparently perceived as less and less likely. In some cases , this can be easily justified. The improvement in the budget deficit leaves the US fiscal outlook exposed only to problems inflicted by a tribal Congress for the next few years. Other issues look more problematic. The easing of the Eurozone debt crisis can be illustrated by the sharp fall in the yield spreads on peripheral government bonds relative to Germany since the Governor of the ECB, Mario Draghi, promised to do "whatever it takes" to save the euro in July 2012 (chart 2). That pledge has not been put to the test, nor has it been backed up by underlying institutional reform. Cyclical factors have helped here, as the Eurozone has pulled out of recession. If this goes into reverse, the effect could be more disruptive than markets currently allow.

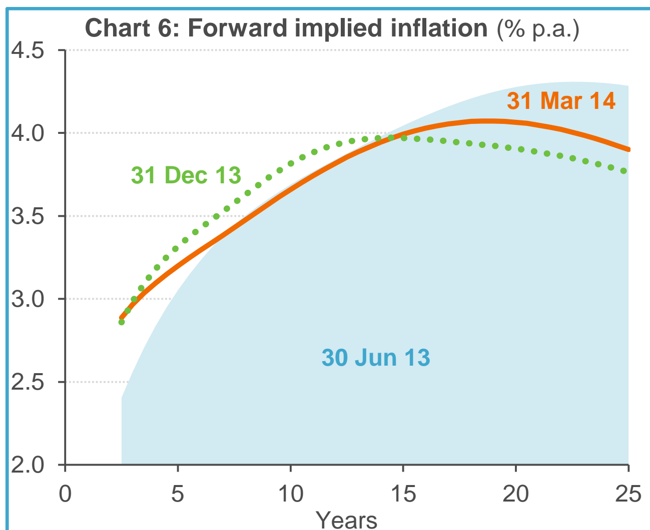
No pressure

Offsetting current risks is the good behaviour of inflation (chart 3), which should give relevant authorities scope to respond to a downturn in the real economy. It is welcome for the US and UK central banks, which are keen to proceed cautiously in tightening policy even if growth is sustained. It should be good news for a Eurozone flirting with deflation, where a monetary stimulus could fulfil dual objectives. Yet, as it did in 2012, the ECB is relying mostly on talk: then, it mainly needed to calm market nerves, now something more tangible may be needed. Perhaps the most interesting case is China, where a substantial slowdown has been a major concern for both the Chinese authorities and global investors. Inflation is low and recent economic data suggest growth is undershooting the official 7.5% target, but so far there have been no significant policy changes. It may be that deflating a huge credit bubble is more pressing.

GOVERNMENT BONDS







A detour on the road to normal

General caution and the particular problems of some emerging economies made for a bright start to 2014 for major government bond markets. However, an initial fall in yields was extended even as market sentiment revived later in the quarter (chart 4). All of this makes valuations less attractive, although the appeal of risk-free assets when risk premiums are so low should not be ignored. The relatively modest fall in the yield on 30-year UK gilts reflects their insensitivity to short-term economic sentiment rather than the buoyancy of the UK economy. 10-year UK and US yields would be much closer. In the US, the fall in conventional yields was more or less tracked by a fall in inflation-linked yields. In the UK, the fall was split more evenly between index-linked yields and implied inflation, perhaps still reflecting the unexpected fall in UK inflation since the middle of 2013.

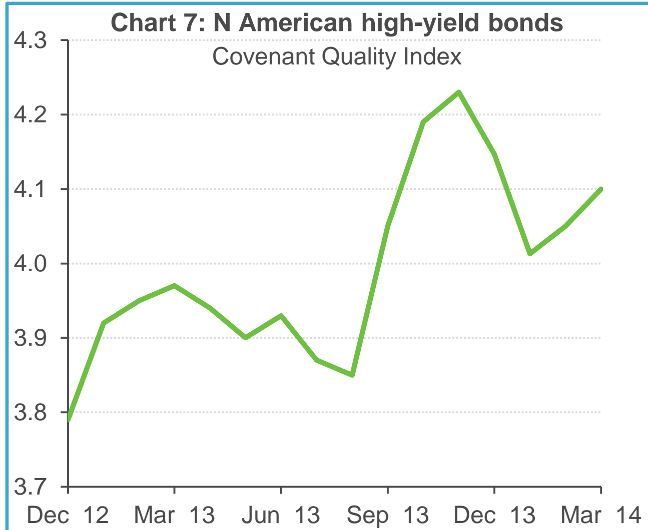
Value destruction

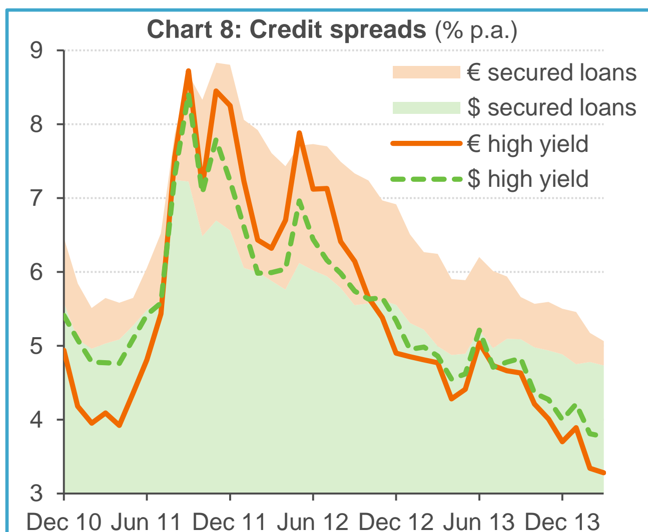
Chart 5 shows how the future progression of interest rates implied by the prices of gilts has changed in the first quarter of 2014. The position in the middle of last year, after the initial setback in bond markets is also shown. At that time, forward yields from around 10 years onward were close to 4.5% p.a. and, in our view, offered fair value in the context of a low-inflation, moderate-growth economy. Subsequent weakness in gilts in the second half of 2013 had little impact on the longest maturities. The consequence was to depress longer forward yields below what we would consider fair value, while creating a bulge between 5 and 15 years. The rally in 2014 has removed that bulge, but longer yields have remained below 4% p.a. Hedging now looks expensive across most of the yield curve. Our view is that short forward yields still rise too slowly. Those who demur may find hedging opportunities at short maturities.

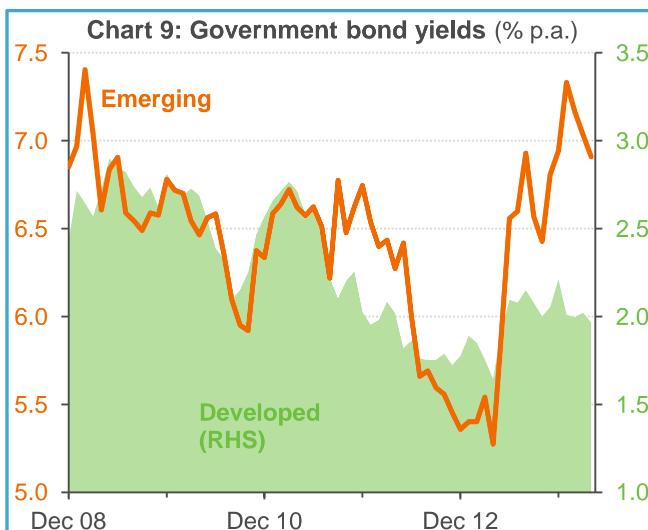
A series of short terms

Chart 6 is analogous to chart 5, but shows future inflation rates implied by yields on gilts and index-linked gilts. Neither chart should be interpreted as forecasts, but implied inflation in particular includes a risk premium over expected inflation that tends to increase with time. In recent years, that premium has been high (relative to a central estimate of 3% p.a. for RPI inflation). It has rarely looked attractive from an investment perspective to hedge inflation, especially at longer maturities. Recent shifts in the forward curve have done little to alter this view. Implied inflation has fallen a little overall (and is well below the levels that prevailed in the middle of last year), but the improvements have been at short maturities, while longer forward rates have increased Our natural bias remains to pay a lower premium and build inflation protection outward from the shorter maturities.

OTHER BOND MARKETS







Quality control

Income-hungry investors have long since picked off the easy prey in their hunt for yield. Their continuing search may turn them into the easy prey. Strong demand attracts supply and eager buyers are not always the most discriminate. However, after very strong issuance at the end of last year, 2014 has been relatively quiet so far. That can simply magnify another problem: in a sellers' market, product quality can suffer. Moody's Covenant Quality Index measures the average level of investor protection in the North American high yield bonds, on a scale of 1 (strongest) to 5 (weakest). The average during 2011 and 2012 was 3.65 and it has deteriorated since then (chart 7). Clients should avoid this race to the bottom. When investing in credit markets, it is more important to determine an appropriate level of risk and then stick with it than to vary risk to target an absolute level of income.

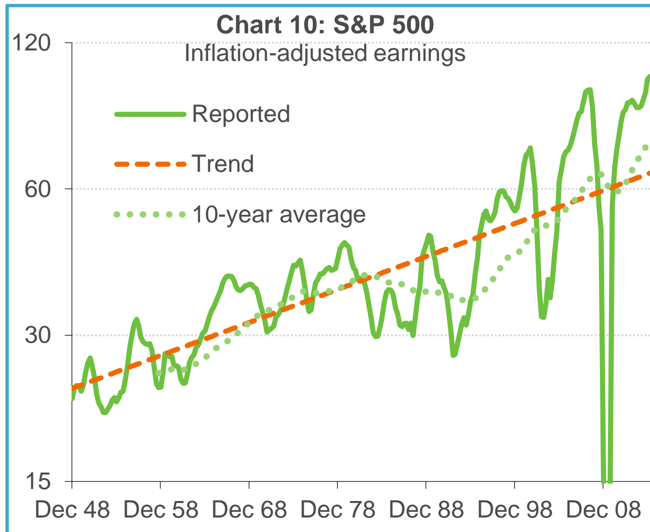
Credit analysis

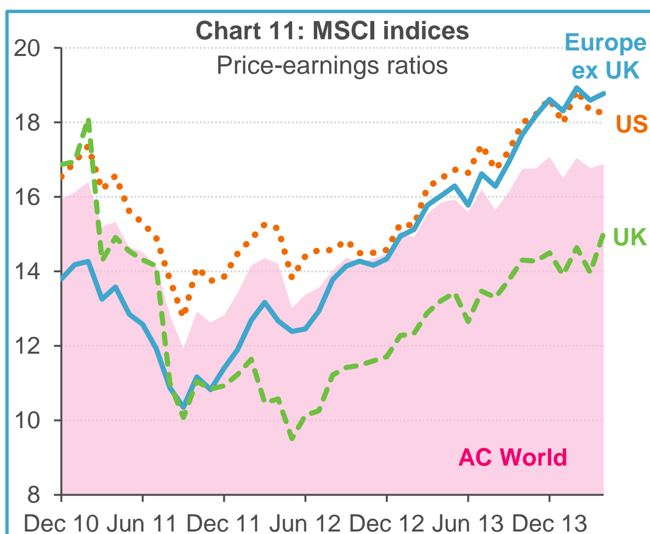
Valuations are getting more demanding in almost all credit markets as yield spreads narrow, but there are still some interesting differences in relative value. A short-term preference for liquidity over security has resulted in higher spreads on secured loans (the light-coloured areas in chart 8) than high-yield bonds (the darker lines). We think long-term investors should have the opposite bias. Within loan markets, we have had a preference for European loans over US loans. Higher spreads on European loans reflect the fact that European retail investors cannot easily invest in loans, unlike their US counterparts. (The same reason helps to explain why the reverse position holds for bonds.) However, institutional demand has been increasing in Europe as the collateralised loan obligation market has re-opened. As loan margins in Europe and the US converge, a more neutral geographical exposure may be appropriate.

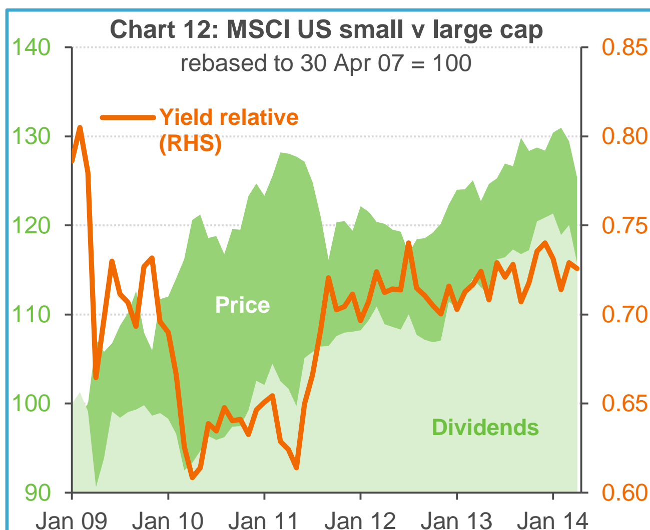
Credit alternatives

January's jitters in emerging market debt (EMD) may have calmed, but local currency index yields are still around 7% p.a., very much towards the high end of the last decade. Currencies have strengthened against the dollar since the end of January; this only takes them in aggregate back to year-end levels. Essentially, EMD remains as cheap as it has been since the immediate aftermath of the Lehmans' collapse (and not much more expensive than it was even then). The travails of emerging markets have emphasised the disparity within the EMD universe rather than its coherence as an asset class. However, it can offer tactical opportunities and diversification from corporate credit (however unwelcome that has been recently). That certainly makes it worth considering for an actively managed return-seeking bond portfolio.

EQUITIES







Facing the headwinds (I)

At a global level, the equity rally of the last three years has been driven by revaluation rather than earnings growth, which petered out in 2011 after recovering sharply from depressed recession levels. The US market has been an exception here. Chart 10 plots inflation-adjusted earnings per share on the S&P 500 index and shows at the right-hand edge a revival in recent quarters. This has taken earnings even further above their post-war trend (based on average growth of just over 1.5% p.a.). A return to that trend would represent a significant drag on US equity returns over the medium term. Earnings still look extended on the assumption of faster trend growth (one that could perhaps be justified by the last 30 years but seems optimistic in light of most long-term economic projections). It seems unlikely that earnings will drive medium-term performance for almost half of the global equity universe.

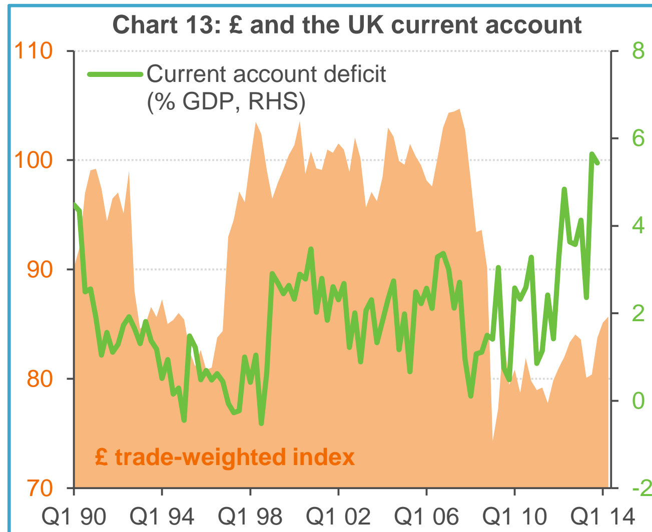
Facing the headwinds (II)

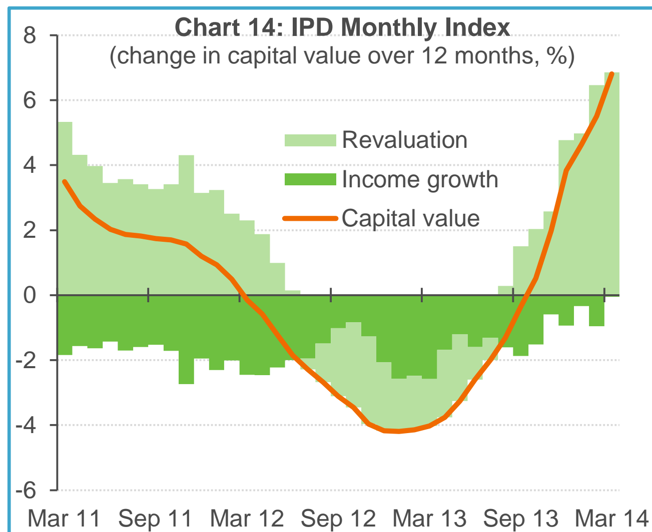
Other markets may have scope to grow earnings more quickly over the medium term. For example, real earnings on MSCI indices for Europe and the UK are still about 40% below pre-recession peaks (although any shortfall from trend will be rather lower). While this gives these markets a better base on which to build medium-term returns, the impact of revaluation has to be considered as well. Chart 11 shows how valuation levels have become extended since summer 2011. Current levels are by no means at historic extremes, but could come under pressure if economies build a self-sustaining recovery and risk-free rates drift higher. (This could well be an additional headwind for the US.) Of course, if the economic background proves tougher, the earnings growth that might drive returns for non-US markets could prove equally hard to deliver.

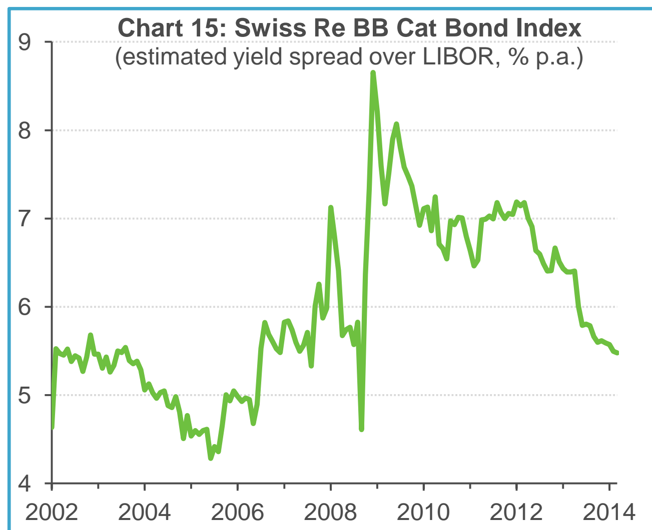
Small claims

Recent US experience illustrates some broader themes in global small cap investment. Small cap have performed well: the MSCI small cap index is 25% ahead of the main index since the end of 2008 (chart 12). Superior dividend growth has played a part but a longer-term history suggests this is not inevitable. In any case, small cap stocks really have to deliver superior growth to compensate for a lower dividend yield. This gap has widened since the end of 2008 (boosting relative performance) and a current dividend yield just above 70% of the main index is not cheap compared to history. The tactical arguments for small cap investment may not be compelling, the rationale should really be strategic: to open up opportunities covering about 15% of the global universe which is otherwise largely ignored. You can't buy the index in any case – you also need to find an active manager able to exploit the opportunities.

OTHER INVESTMENTS







Attention! Deficit disorder

Sterling maintained its momentum into 2014 as the UK economy bucked the trend of moderating growth. In April its trade-weighted index reached a five-year high (chart 13). Currency momentum can be powerful and persistent and sterling is still almost 20% below its 2007 highs, but sentiment may already be running ahead of reality. The deterioration in the UK current account is already much worse than in the late 1990s and early 2000s after a much larger rise in sterling. Our advice has been and remains that clients should avoid tinkering with currency strategy. However, those who have hedged should have banked some profits in recent years, while long-term valuation measures do not point to sterling being cheap. If the operational aspects and/or costs of hedging have proved inconvenient, this could represent an opportunity for a relatively graceful exit.

Still waiting for the rent

It was no great surprise that UK property returns in the first quarter did not match the near-5% of the previous quarter, but the rally retains considerable momentum. The total return on the IPD Monthly Index in the 12 months to March was 14%. This includes a 7% was a rise in capital values, which is entirely explained by revaluation (chart 14). This can be rationalised as catch up: property valuations languished until the middle of 2013, while valuations in many other markets were increasing. However, the latest spurt in property has taken the income yield on the IPD Monthly Index below 6% p.a. for the first time in over 5 years. And while rental growth has stabilised, there is little sign of the growth that might sustain future returns. Funds that are below target in property should be in no rush to close the gap. Those with long-terms plan to reduce exposure should be more expeditious.

Hunted down

Insurance-linked securities (ILS) have been just as caught up in the search for yield as many other asset categories. Our estimates suggest that yield spreads on catastrophe bonds are at a level as low as they have been able to sustain since before the credit crunch (chart 15). As with credit, the primary market has responded: new issues of catastrophe bonds in 2014 have been higher than for many years. Of course, valuations across many asset classes are demanding, and so the relative attractions of ILS are not necessarily diminished. The strategic case – insensitivity to economic factors – remains intact. And there are plenty of less liquid ILS opportunities other than catastrophe bonds that investors can exploit. However, here too, investment should be structured to match risk appetite, not to chase a particular level of return regardless of price.

Capital Markets Service

MARKET RETURNS 2014 (%)				Local currency		Sterling	
UK	April	Q1	OVERSEAS	April	Q1	April	Q1
EQUITIES	2.2	-0.6	**EQUITIES**				
BONDS			North America	0.7	2.1	-0.5	1.2
Conventional gilts	0.7	2.1	Europe ex UK	1.2	3.6	0.4	3.0
Index-linked gilts	0.9	3.2	Japan	-3.4	-7.3	-3.8	-6.0
Credit	1.1	2.4	Developed Asia ex Japan	1.4	0.2	0.8	1.0
PROPERTY	n/a	3.9	Emerging Markets	0.3	-0.8	-0.8	-0.7
STERLING			**GOVERNMENT BONDS**	0.6	2.1	-0.2	2.0
v US dollar	1.3	0.7	**HEDGE FUNDS** *	n/a	0.9		
v Euro	0.7	0.6	**COMMODITIES** *	1.2	6.1		
v Japanese yen	0.5	-1.4	** Local currency = $; Property and Hedge Funds to 31 March*				

SOURCES

CHARTS

Babson Capital, Bank of England, Bloomberg, Datastream, Hymans Robertson, IPD, Moody's, 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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