HYMANS ROBERTSON
The Spirit of Independence

capital markets service

Quarterly update Q3 2014

Meanwhile, back in the real world …

Graeme Johnston

The last few months have been more interesting for students of geopolitics rather than followers of investment markets. Any risks from disruption in the Middle East or Eastern Europe or rising tension in the South China Sea have done little to dent the progress of markets.

To be fair, the broad picture from economic data still tends to confirm the consensus expectation that global growth will be faster this year than in 2013. Even where inflation and economic growth point to an end to emergency monetary accommodation, in the US and UK for example, subdued wage growth currently supports the desire of central banks to have a measured rise in interest rates. A collapse in the values of risk assets is not inevitable. Nevertheless, both the relative performance of the last two years and the further attenuation of risk premiums suggest this is a time to be reducing investment risk, buying bonds and other low-risk assets or holding a little more cash, as circumstances dictate.

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> Nevertheless … this is a time to be reducing investment risk.
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Government bonds (p3)

If our bias is to de-risk, it has to be noted that gilts have got more expensive in recent months. There is now no part of the yield curve that appears consistent with sustained nominal growth at levels close to pre-crisis norms. Our preference remains to be short of duration.

The latest fall in long-dated gilt yields has happened while real yields on index-linked have barely moved. Long-dated inflation protection is consequently as cheap as it has been for 18 months. There is still a large gap between the prices of short- and long-dated protection and, here too, we still prefer to hedge at shorter maturities.

Credit markets (p4)

It is still the case that we would expect credit to play an increasingly important strategic role for pension funds. Tactically, our bias would be to reduce credit risk in bond portfolios. Diversification is as important for credit as it is elsewhere. Areas such as local currency emerging market debt (to stretch the definition of credit) and secured loans look more attractive than traditional investment-grade and high yield bond markets.

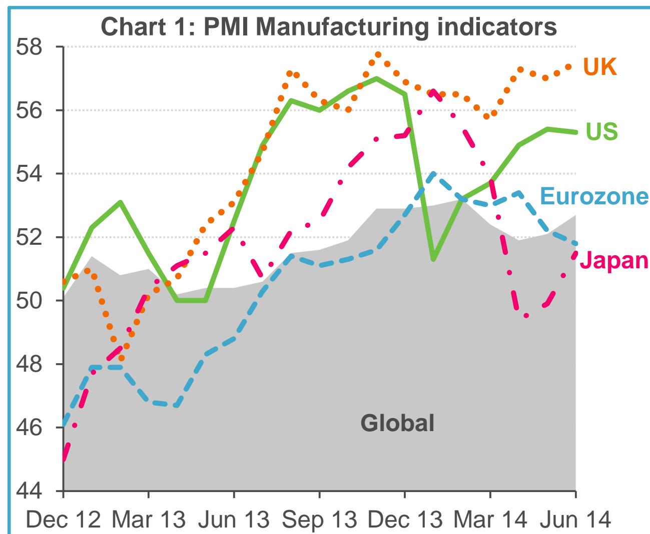
Equities (p5)

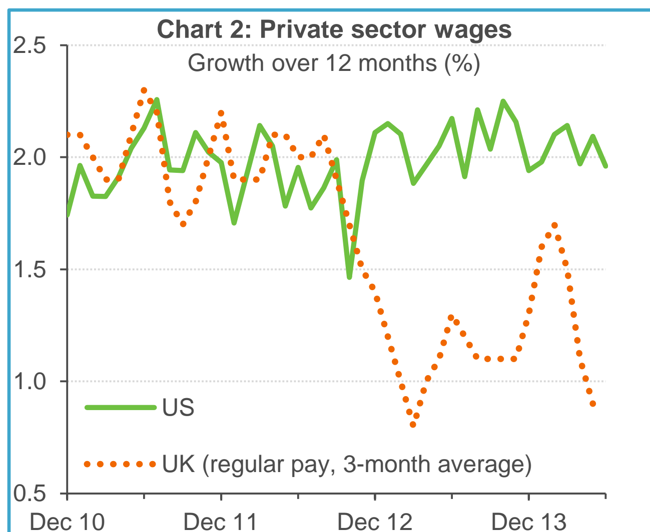
A high level of confidence is more often a precursor of a fall in confidence than a collapse in equities, but the associated market rallies tend to steal returns from the future. Recent pedestrian earnings performance at a global level does offer potential for some decent growth in the future, but the benefit could be offset by a reversal of the revaluation that has sustained markets in the rally of the last three years. The improving economic background that might drive the earnings growth will tend to mean a tougher valuation comparison against higher risk-free rates.

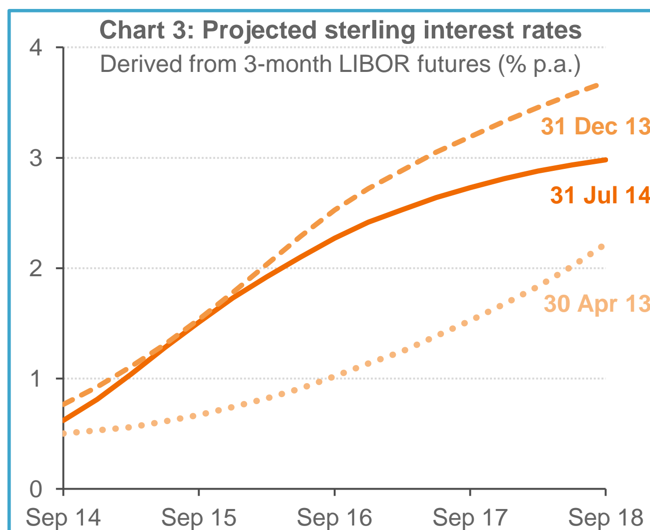
Property (p6)

Both in absolute terms and relative to equities, property looks no better than average value relative to history. In current market conditions, average is as good as you're likely to get anywhere; those with their money invested have no reason to sell. It is becoming more difficult to justify paying the costs to invest more and easier to justify taking profits where the long-term strategy is to reduce exposure.

MARKET BACKGROUND







The survey says …

PMI manufacturing indicators, derived from business surveys, can often provide a timely guide to developments in the broad economy. (As a reminder, readings over/under 50 are consistent with expansion/contraction.) The correspondence is not always precise, but recent trends provide a useful shorthand summary. So, chart 1 indicates:

- the persistent strength in the UK economy;
- a rebound in the US after a dip at the start of the year;
- strength and weakness in Japan around the rise in consumption tax; and
- renewed signs of slowdown in the Eurozone after its slow climb out of recession.

Whatever the particular divergences across and concerns about individual regions, the more consistent picture of a continuing modest global expansion provides some support for the current sanguine disposition of markets.

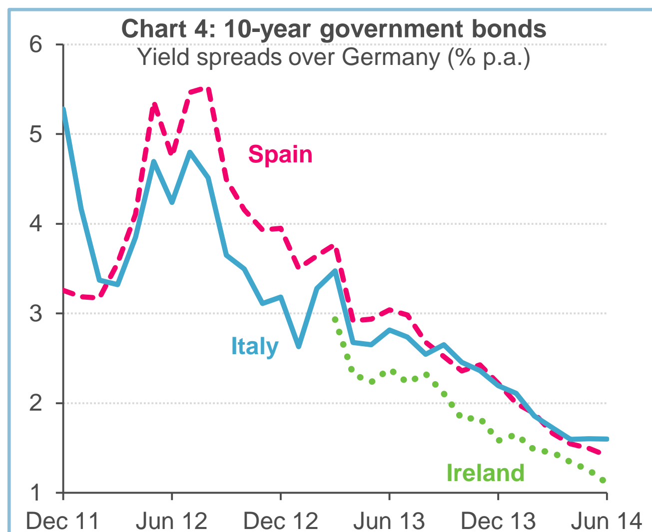
Wage restraint

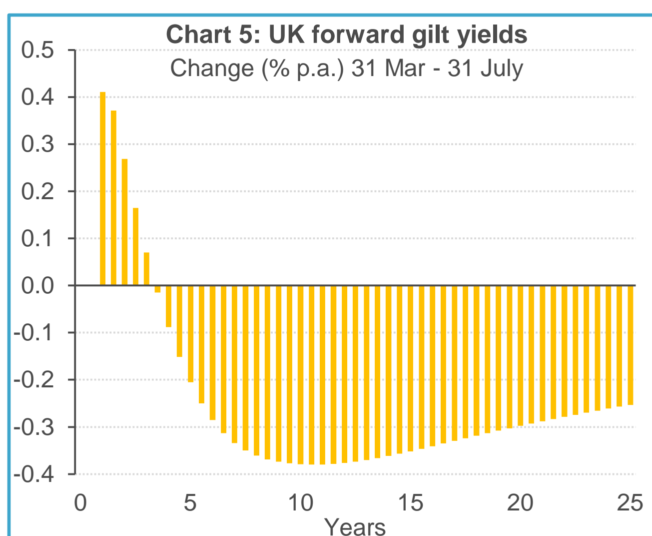
The US and UK economies are both growing at reasonable rates and have inflation close to the (formal or informal) 2% p.a. target. It is no surprise that the Bank of England and the US Federal Reserve are talking more freely about rises in interest rates. But both are keen to emphasise that they expect any rise to be gradual. Here, they can point to the restrained growth in wages (chart 2). A steady economic progression in the US has been matched by very stable wages growth. UK wage growth fell back towards recession lows as the economy stagnated, but has shown no sign yet of rebounding as the economy booms. Of course, the Bank and the Fed have recently misread the labour market – unemployment has fallen much more quickly than they forecast. Wages could surprise them, too. Any signs of upward pressure will be a significant determinant of whether the rise in interest rates can be as controlled as they wish.

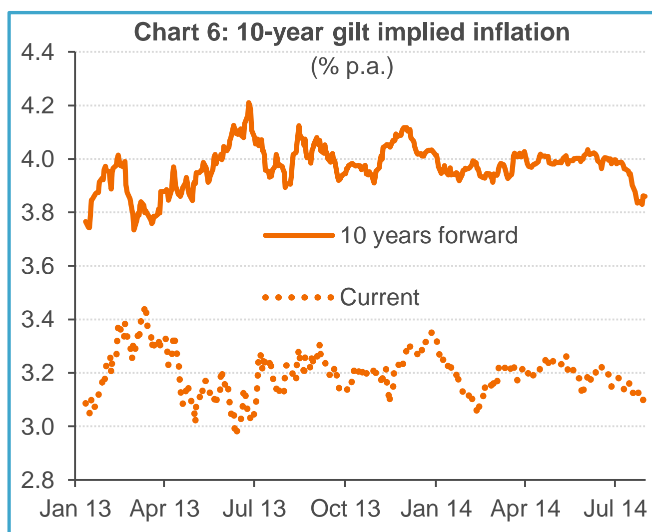
A little lower for a little longer

The behaviour of interest rate futures suggests that central bank rhetoric may be having some effect. For much of 2013, the path of interest rates implied by futures markets was becoming steeper (chart 3). This reflected improving economic growth in the UK and (on a more subdued level) the Eurozone and the prospect of an end to QE in the US. This trend went into reverse at the start of 2014 and that has continued in recent months. The initial rise is projected to be faster in the UK than in the US, perhaps an acknowledgment of the strength of recent growth. However, rates in both countries are now projected to be only 3% p.a. in four years' time. The situation in the Eurozone is more extreme. Projected rates had fallen back to April 2013 levels by March this year and are now even lower, reaching 1% p.a. only late in 2018.

GOVERNMENT BONDS







Euro enthusiasm

The implied outlook for interest rates in the Eurozone would suggest concerns that the current combination of minimal growth and negligible inflation could persist. This is the sort of environment more likely to stoke Eurozone tensions than douse them. Imbalances in the Eurozone payments system remain high, indicative of a continuing tendency for capital to flee from the periphery to Germany. It is therefore surprising that the yield spreads on peripheral government bonds relative to Germany continue to decline. Spreads are now as low as they have been for over three years. The ECB has taken further measures to ease policy, but doubts remain whether they can or want to do everything it takes to preserve the euro. If there are doubts that the ECB can succeed in their primary goal of keeping inflation around 2% p.a., the risk that they won't succeed in the broader task seems meanly rewarded in bond markets.

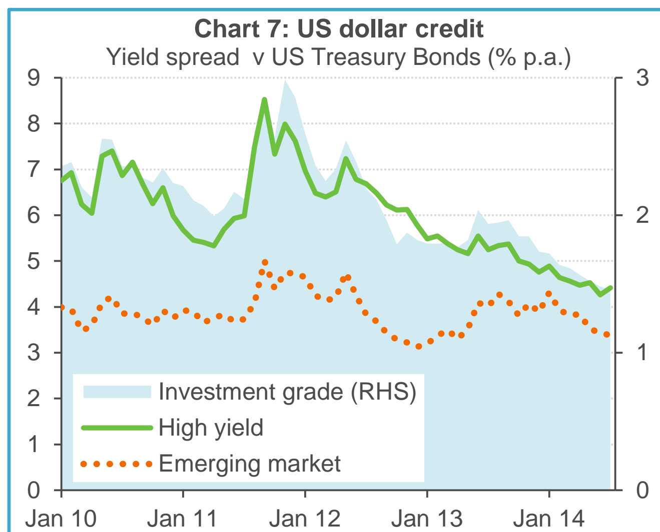
Shape shifting

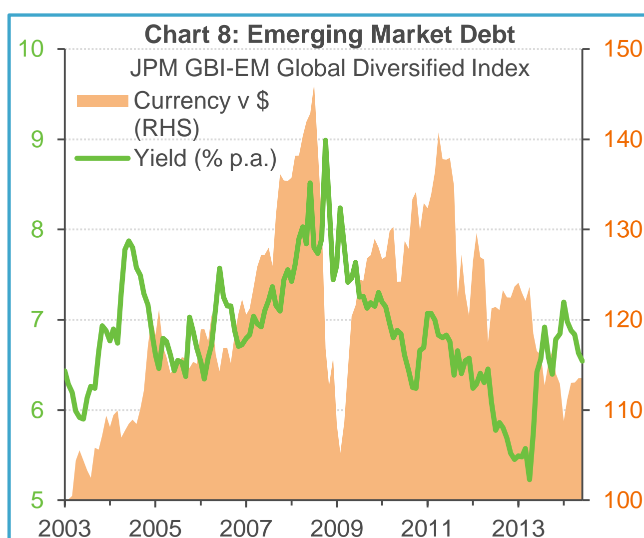
Long-dated gilt yields have fallen further since the end of the first quarter, although the overall reduction this year has been less than in equivalent US and German yields. As has been the case for some time now, the changing shape of the yield curve has been at least as interesting as the change in the overall level of yields. Chart 5 shows the change in forward gilt yields (the future levels of very short risk-free interest rates implied by gilt prices) between the end of March and the end of July. As was the case in Q1, the biggest reductions have been in the 5-15 year area. Forward yields are now below 4% p.a. at almost all maturities, significantly so at longer maturities. Based solely on relative performance, this is almost as good a time as any in the last five years to de-risk from equities and gilts. However, given the absolute level of yields, we are still inclined to seek interest rate protection at shorter maturities.

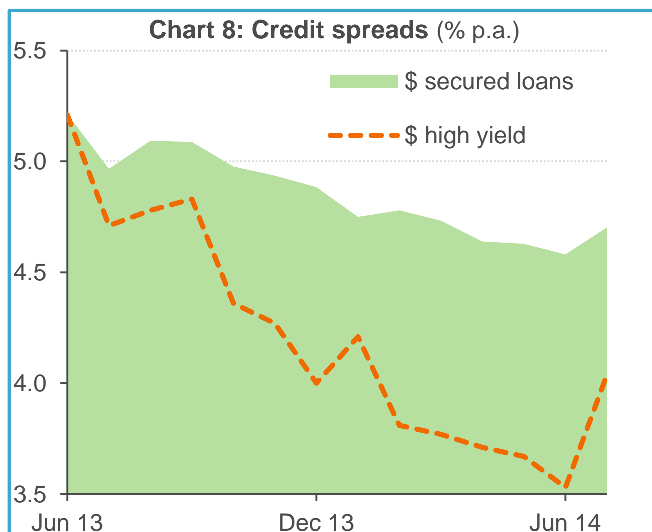
Inflation protection – the long and short

In the US, the latest downturn in long-dated government bond yields has been matched by a fall in real yields. In the UK, there has been a fairly even split between lower real yields and lower implied inflation. As a consequence, long-dated implied inflation has fallen close to 3.5% p.a., as low as it has been since markets were pricing in a change to RPI calculations in late 2012. Given discretion, our preference is still to hedge inflation at the lower prices available at shorter maturities (chart 6). Taking 10 years of inflation protection now will still be cheaper than taking 20 years, as long as the cost of 10 years' protection is below 3.8% p.a. in 2024. However, a premium of only 0.5% p.a. over the RPI equivalent of the 2% p.a. CPI target may well be of interest to those for whom reducing long-term inflation risk is a key priority.

OTHER BOND MARKETS







Reducing credit balance

Yield spreads on UK investment-grade corporate bonds have been relatively stable since late last year. As chart 7 suggests, this has been a little at odds with the trend in wider credit markets, where spreads have continued to decline. (There has been some comment about the tough time high yield bonds have had in recent weeks, but that barely registers on the chart.) Valuations are still well short of historic extremes, but as demanding as they have been since the early days of the credit crunch seven years ago. This reinforces our existing view. Strategically, we think credit has an increasingly important part to play for pension funds; tactically, we would look to reduce risk in credit portfolios. Another theme is highlighted by the modest divergences between emerging market and corporate credit. Credit markets will all tend to rise and fall together, but it is still well worth seeking as much diversification as possible.

Think local

Emerging market debt (EMD) is increasingly focused on local currency bonds. These are not, strictly speaking, credit markets – the borrowers are generally governments issuing in a currency they control. Nevertheless, for non-domestic investors, they share with credit markets the characteristic that they are generally held for the returns they offer rather than risk reduction. Local currency EMD has recovered a little from last year's weakness but, in contrast to most credit markets, yields on the main indices are still well above recent lows (chart 8). Local currency EMD also brings currency risk. We are sceptical that this is inevitably a good thing (and history is on our side), but the exposure can be acquired relatively cheaply by the standards of the last decade. The claims for the inclusion of local currency EMD in a return-seeking bond portfolio are as strong as they have been for some time.

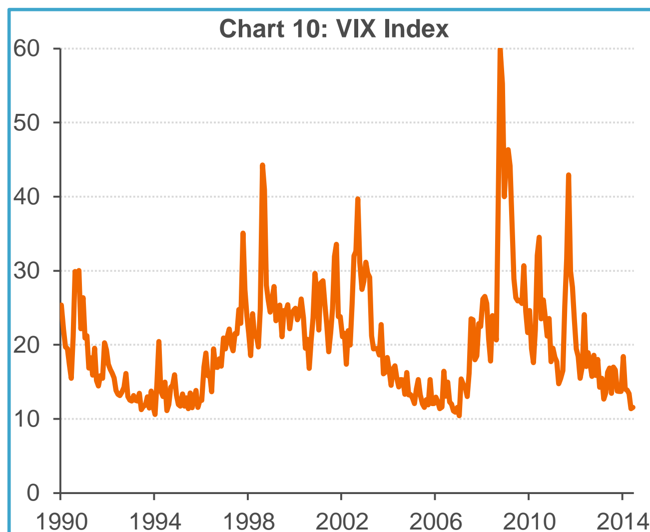
Looking for security

Some investors, such as those with a long time horizon or seeking to match cash flows, can exploit illiquidity premiums in private debt markets. Those without that flexibility can still consider the secured loans market, where the sacrifice of liquidity is less – some secondary trading does take place. Broadly speaking, the quality of borrowers is lower than in high yield bonds, but the covenant protections for lenders are greater. (That said, the overlap between issuers in the markets has been increasing in recent years.) As chart 8 shows, investors have been seeking liquidity rather than protection over the last year in particular; the divergence is even more marked in euro markets. Default levels have been low in recent years; protection against it is relatively cheap. Secured loans are another diversification well worth considering currently for credit portfolios.

EQUITIES

The height of confidence

The VIX index is derived from the prices of options in US equities and gives a guide to investors' expectations about market volatility. It is sometimes known as the Fear Index – the highest readings in chart 10 coincide with the Asian currency crisis, the collapse of Lehman Brothers and the height of the eurozone crisis. A low reading – it is currently very low – is sometimes seen as a sign of overconfidence. But it is perhaps safer to suggest that the VIX will rise from here – that is what futures markets imply – than that an equity downturn is inevitable. The last trough, in early 2007, was followed by market weakness and subsequent collapse, but equities were strong for several years after the one in the mid-90s. Then, rising earnings and revaluation provided support. We have reservations that investors can place too much reliance on either this time.

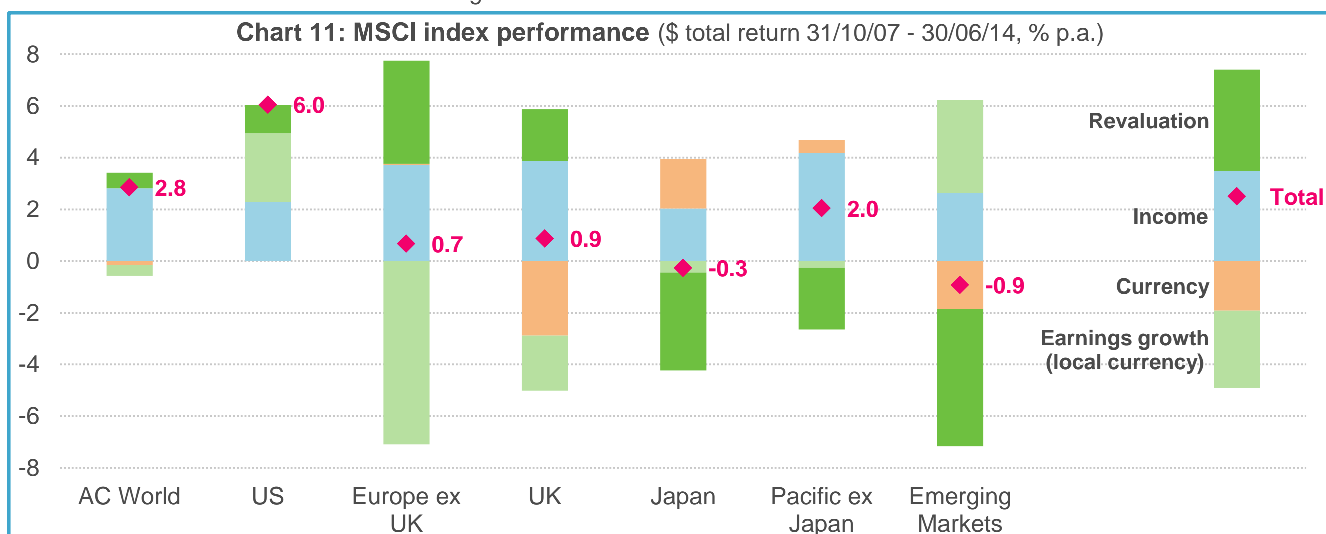


Scaling the peaks

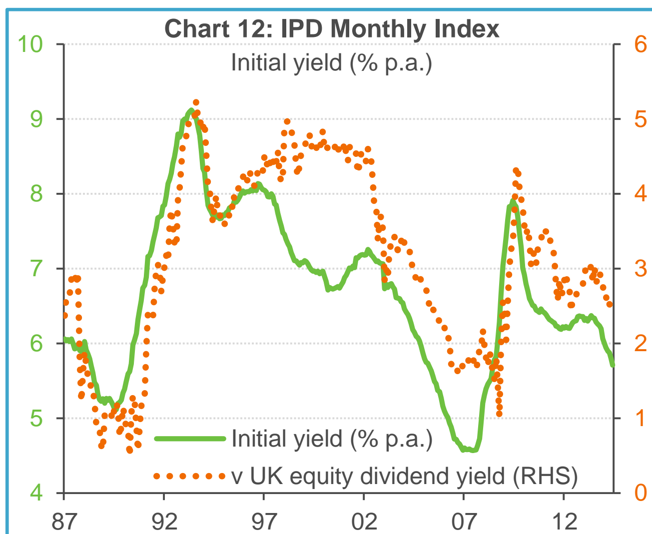
Chart 11 analyses the total return (in $ terms) of regional equity markets since the end of October 2007, just as equity prices succumbed to the credit crunch and shortly before reported earnings peaked. At a global level (the left-hand bar), prices have stagnated – equities have returned income and nothing else. A modest boost from revaluation (a rise in PE ratio) has been offset by a combination of currency weakness relative to the dollar and a fall in underlying earnings. However, the split varies considerably across regions and provides some pointers to what might (or might not) drive returns in the future.

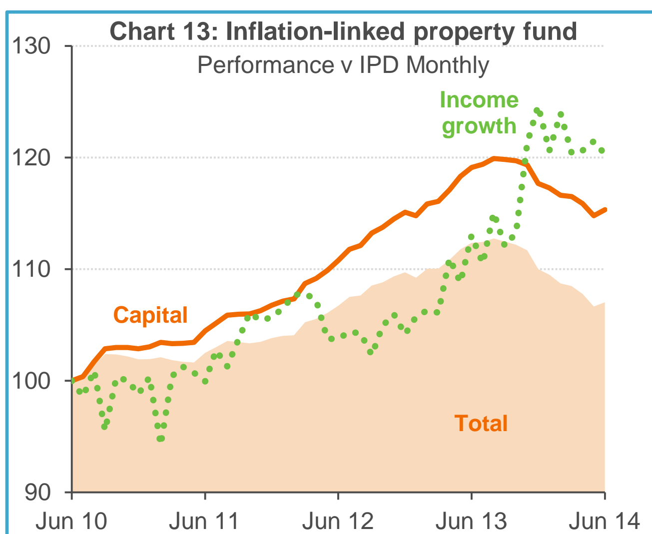
- US earnings have left pre-crisis highs well behind and, with profit margins at peak levels, the risk of an earnings downturn has risen. Valuations are far from historic extremes, but more demanding than at the market highs of 2007.
- A plunge in earnings in Europe certainly offers potential for future returns, but some of that has already been discounted by a revaluation that has been much greater than in the US. More fundamentally, the risk of a Japanese-style secular stagnation that would postpone any normalisation of earnings cannot be ignored.
- As in the US, emerging market earnings are well above pre-crisis peaks. However, they are in a different cyclical position – a rapid recovery has been followed by a few years of downward drift. Valuations look less extended than those in developed markets. In relative terms, the opportunity remains as attractive as it has been for a long time.

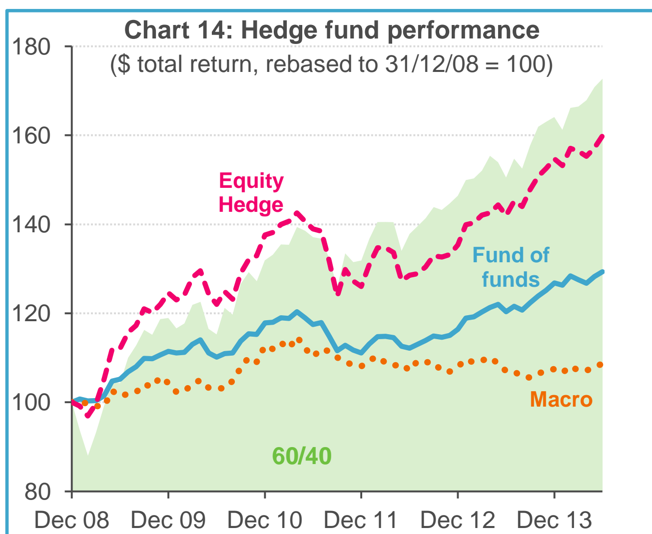
Of course, the analysis here is limited by the choice of start and end dates. To take an example, the devaluation of Japanese equities might more easily be rationalised as the final stage of a return to reality rather than a value opportunity. However, as the reverberations of the financial crisis fade, comparisons that ignore the massive distortions of recent years will become more and more relevant for long-term investors.



OTHER INVESTMENTS







Building momentum

The return on UK commercial property, as measured by the IPD Monthly Index was almost 17% in the year to June. The equivalent rent index was just over 1% higher. Rental yields have consequently fallen to their lowest levels for 8 years and are far from cheap relative to history (chart 12). Valuations relative to equities have become a little more stretched – property has outperformed both UK and overseas equities, but dividend growth has been no worse than rental growth. None of this suggests any urgent need to sell property, but it does reduce the attraction of making further investments. Acquiring property in a rapidly rising market usually means paying well above valuation prices, or waiting in a queue as valuation prices rise. Those looking to sell should not overlook the worth of dealing at good prices; holding on for something better carries the risk that liquidity might dry up.

A defensive option

Inflation-linked funds have been one of the most successful ways to invest in UK property in recent years. In principle, it is a defensive strategy: investors should be willing to sacrifice yield in return for greater income stability and guarantee of growth. It would therefore be no surprise if these funds lagged in a more general market rally. That has been the case for the fund illustrated in chart 13, where return has lagged the IPD Index by 10% in the last year. At the same time, income growth has been particularly strong in the inflation-linked fund. The yield on the fund is still below the index yield, but the gap is as narrow as it has been since 2008. Inevitably, there will be factors specific to this particular fund in recent performance, but this type of strategy (where we have expressed reservations in the past) may be worth revisiting where it can meet a strategic need.

A genuine alternative

In aggregate, hedge funds have had an unspectacular first half of 2014 and still struggle to reclaim their lustre of the years before the financial crisis. Chart 14 compares hedge fund returns with a passive traditional strategy – 60% global equities, 40% government bonds. Hedge fund strategies, even those highly correlated to equities, have failed to keep pace since 2008, with funds of funds signally failing to justify their cost structures. Hedge fund volatilty has been lower, but we think investment should be predicated on genuine diversification from equities rather than a modest reduction in risk. Ironically, that is easiest to find in strategies such as Macro, which have been among the poorest performers. Of course, any hedge fund investment is critcally dependent on the selection of skilled managers, but genuine diversification could be particularly valuable now that traditional risk premiums have become so compressed.

MARKET RETURNS 2014 (%)				Local currency		Sterling	
UK	August	Q2	**OVERSEAS**	August	Q2	August	Q2
EQUITIES	-2.1	2.2	**EQUITIES**				
BONDS			North America	0.0	5.3	0.5	2.9
Conventional gilts	1.6	1.1	Europe ex UK	-3.4	3.4	-2.6	0.0
Index-linked gilts	1.9	1.0	Japan	-4.8	5.2	-3.4	4.3
Credit	1.0	2.0	Developed Asia ex Japan	-3.0	2.3	-2.9	2.0
PROPERTY	n/a	5.1	Emerging Markets	-1.0	7.1	-0.9	5.0
STERLING			**GOVERNMENT BONDS**	0.5	1.8	1.3	-0.3
v US dollar	-0.5	2.6	**HEDGE FUNDS ***	n/a	1.9		
v Euro	-0.8	3.2	**COMMODITIES ***	-0.7	-0.8		
v Japanese yen	-1.5	0.9	** Local currency = $; Property and Hedge Funds to 30 June*				

SOURCES

CHARTS

Babson Capital, Bank of England, Bloomberg, Datastream, Hedge Fund Research, Hymans Robertson, IPD

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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