HYMANS ROBERTSON

capital markets service

Quarterly update Q3 2015

Countdown

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While the Greek debt crisis, Chinese equity collapse and thawing of relations with Iran have provided some interesting geopolitical highlights, broad global economic developments in the last few months have been broadly in line with previous expectations. A continuation of relatively benign economic conditions now seems likely to prompt a US interest rate rise before the end of the year.

Global growth has not really provided any positive surprises, but the slowdown in China has not intensified and, of the major developed economies, only Japan seems to be struggling to maintain momentum. Any disappointments have been tempered by the prospect of an economic boost from the renewed weakness in oil prices. Headline inflation remains close to zero in developed Western economies, but core inflation has given no hint of impending deflation.

> "A continuation of relatively benign economic conditions now seems likely to prompt a US interest rate rise before the end of the year."

Government bonds (p3)

The rise in conventional gilt yields since January has been dramatic, but it merely returns them to the levels of last October. The start of monetary tightening in the US and UK may unsettle the market in the short term, but the real risk for gilts is the prospect that rates will eventually rise higher than the peak, of just above 3% p.a., implied by the yield curve.

Index-linked gilts are just as exposed to the risks of rising nominal yields. The implied cost of inflation protection still looks reasonable at shorter maturities, but it has become more expensive. We see no reason to prefer index-linked gilts to conventional gilts.

Credit markets (p4)

In general, yield spreads are relatively high by the standards of the last couple of years, but no better than average on a longer perspective. Credit markets are a long way from offering an outstanding tactical opportunity, but reasonably valued for any strategic role – to boost return in a low-risk bond portfolio or to diversify an equity-dominated growth portfolio.

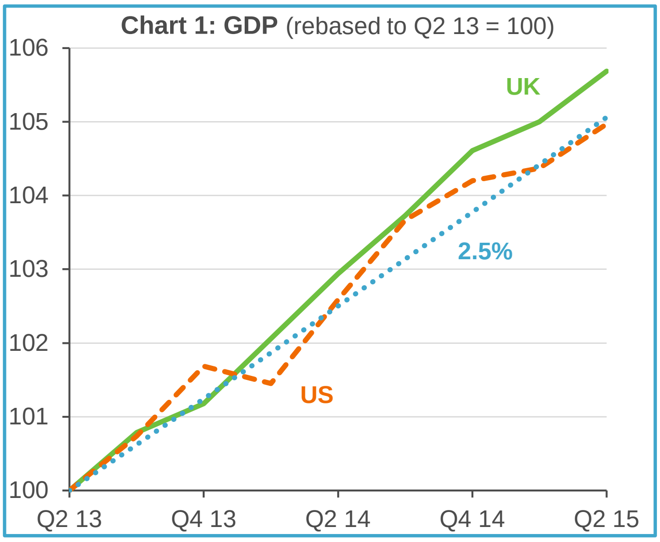
Equities (p5)

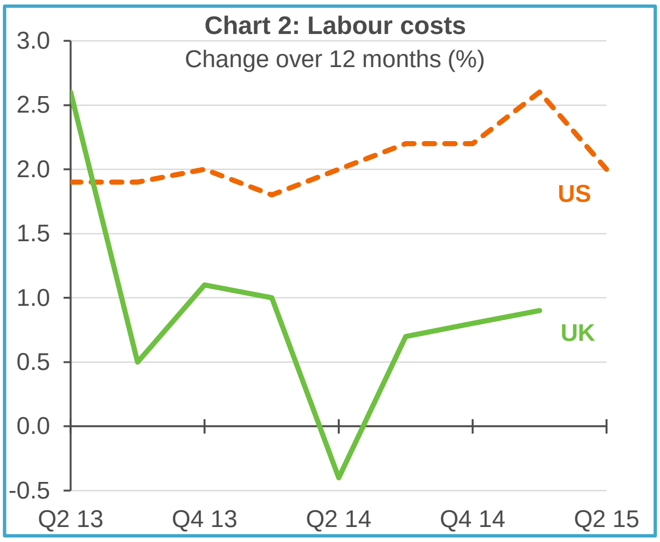
Equity markets have made some concessions to current headwinds, but the fall in global indices from the highs of late-April is modest and does little to remedy our medium-term view that neither earnings growth nor revaluation can sustain anything other than very low returns. The position is, if anything worse, if economies and interest rates normalise – our central view – as that increases the pressure on valuations. However, the implications for profits growth of the circumstances in which interest rates do not normalise give few grounds for optimism.

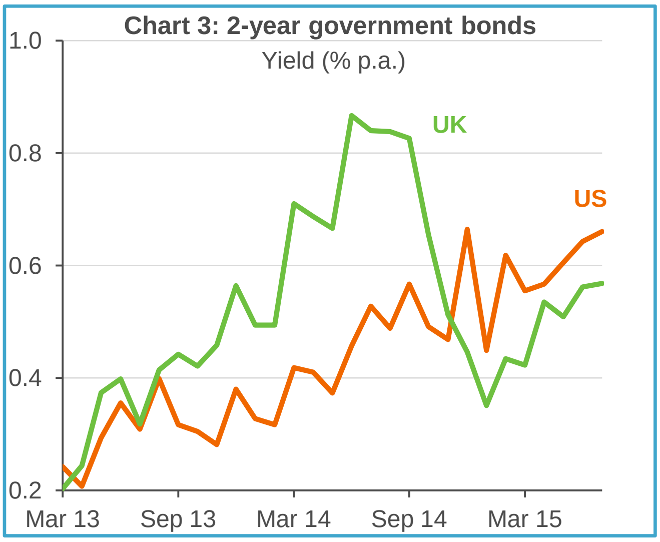
Property (p6)

Capital values continue to push ahead month by month at a healthy pace – income yields are as low as they have been since the end of 2007. Returns are likely to be subdued over the medium term. That does not necessarily disadvantage property relative to other assets, but it does argue against incurring the cost of additional investment. Instead, current conditions provide an opportunity to implement any plans to reduce strategic exposure on attractive terms.

MARKET BACKGROUND







Out of intensive care

On balance, second-quarter data provided more comfort than concern about global economic growth. The slow improvement in the Eurozone seemed little dented by Greece's problems, while recent policy easing seemed to have provided some short-term stability to the Chinese economy – though not (see later) its stock markets. Both the UK and US saw quarterly growth bounce back from a first quarter slowdown. US growth over the last two years has averaged 2.5% p.a. and the UK has done a little better (chart 1). This is hardly exciting after a subdued recovery from recession, but it is no lower than most estimates of sustainable trend growth in both economies. And a prolonged lack of excitement is not necessarily irrelevant. The rationale for having monetary conditions on crisis footing is less convincing the longer there is no crisis.

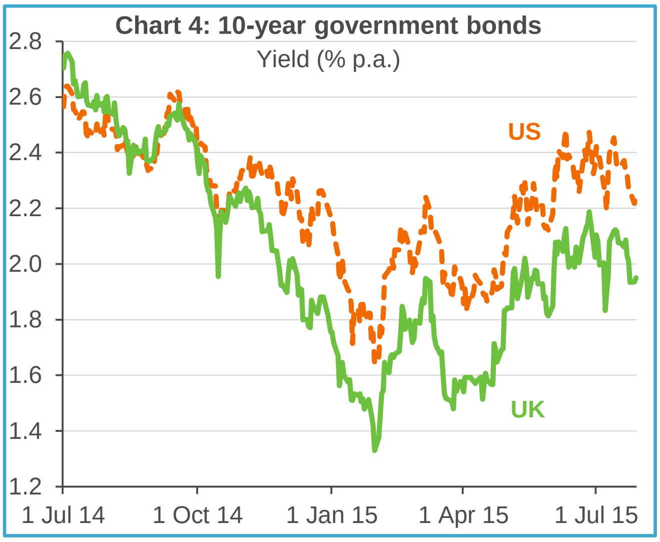
Wage restraint

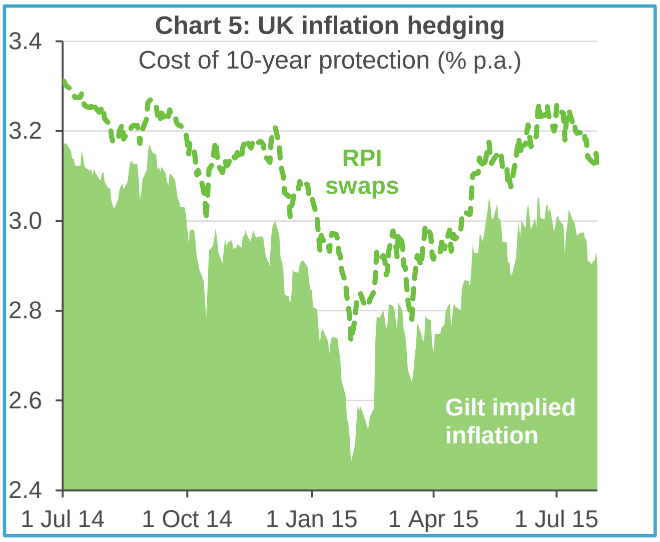
There may be no growth crisis, but there is little sign of any inflationary danger in the UK and US, where headline inflation remains around zero. External price pressures are subdued: the oil price has weakened again and both sterling and the US dollar remain strong. Domestic prices look well contained, too. Weak growth in the second quarter has brought the annual growth in broad labour costs in the US back to 2% (chart 2). The equivalent UK figure has not been released yet, but a further modest acceleration of costs would actually be more compatible with the official inflation target. Narrower measures of wage growth have picked up in recent months. Nevertheless, the Governor of the Bank of England has noted that a UK rate rise in 2015 remains a possibility. 2016 is still more likely, but in the US the Federal Reserve has been more actively preparing the ground for an interest rate rise as early as September.

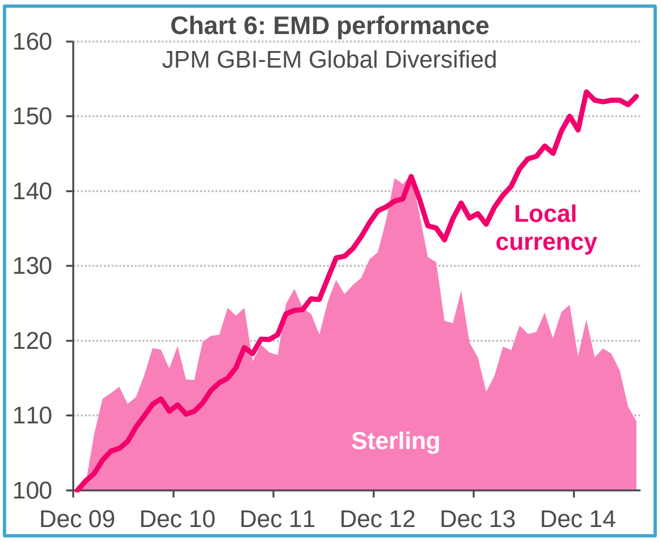
Freedom of information

Transparency is the watchword for the Fed's conduct of monetary policy. They do not want their actions to come as a surprise to investors. From that perspective, the gradual upward trend in 2-year US government bond yields – often cited as a shorthand guide to investors' expectations about the short-term outlook for interest rates – may be counted a success (chart 3). (The UK experience has been more erratic.) But the Fed's growing desire to get the process of monetary tightening underway may reflect wider concerns: that the economic benefits of zero interest rates are increasingly offset by their potential to distort financial markets. It is not obvious that, beyond the short end of the government bond market, investors' risk appetites have been making a gradual adjustment. For all the careful planning, the reality of the first US interest rate rise since 2006 may still unsettle markets.

GOVERNMENT BONDS







Upward revision

The recent reversal in bond markets was perhaps most strikingly illustrated in Germany, where 10-year government bond yields fell close to zero in mid-April, before climbing almost to 1% p.a. US and UK bonds followed a similar pattern, although the change in direction came at the end of January (chart 4). The climb in yields has only taken them back to the levels of the last quarter of 2014 –very low on any longer-term perspective. Gilt prices still imply that short interest rates will barely rise above 3.5% p.a. for the next few decades. This is certainly consistent with the Bank of England's current view that interest rates will rise to lower than normal levels in the next cycle; we are less inclined to believe that it will be different this time. Nominal UK GDP growth has already crept back above 4% p.a., the bottom end of the pre-recession range. If that persists, we think implied interest rates and gilt yields have further to rise.

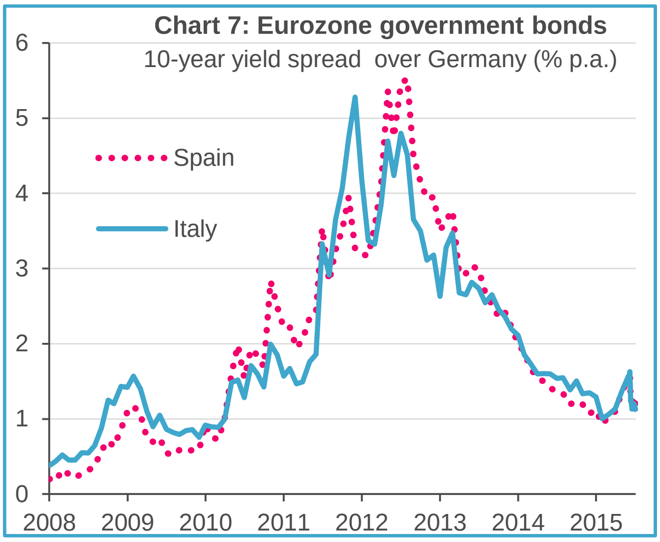
A more modest upward revision

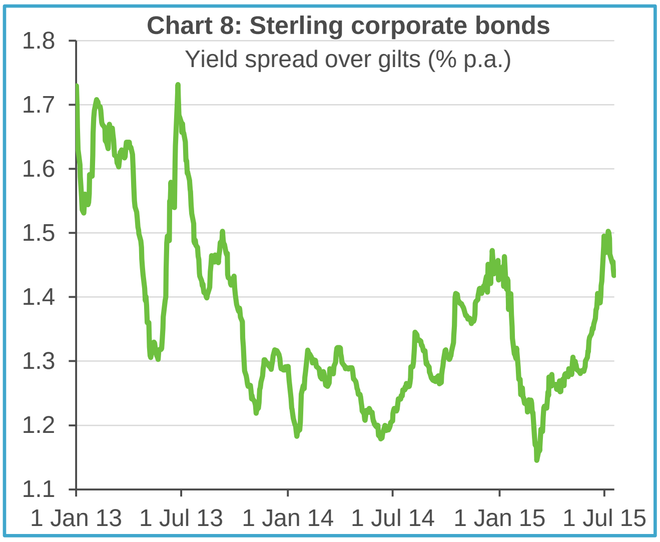
The cost of gilt-based inflation protection has risen since the end of January (chart 5). Index-linked gilt yields have risen, but the rise has been smaller than in conventional gilts. RPI swaps are more expensive as well – prices have tracked gilt implied inflation plus a premium of around 0.2% p.a. There may have been better opportunities to increase inflation hedging earlier in the year, but current prices do not look demanding relative to a neutral long-term expectation for RPI of 3% p.a. (the official 2% p.a. CPI target plus a formula gap of 1% p.a.). This is particularly true at shorter maturities, up to 10 years or so, even allowing for the current low level of inflation. Where circumstances have prevented earlier action or changed financial conditions now permit action, we would not discourage increasing inflation protection at current levels.

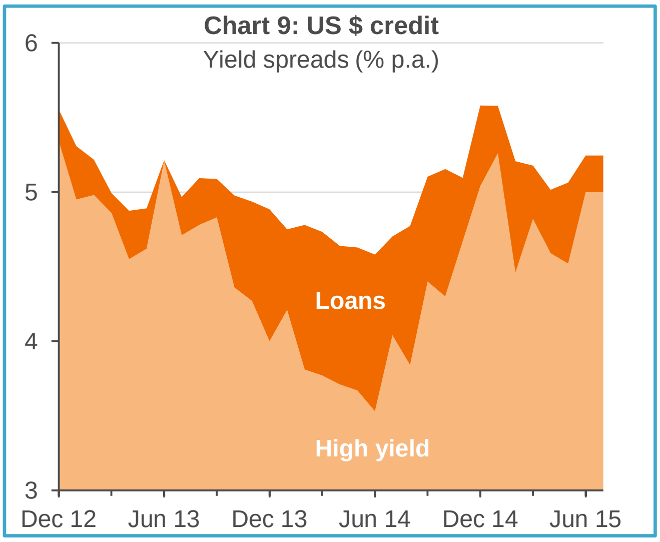
Arrested development

Yields on government bonds in emerging markets have also been rising since January. In local currency terms, the total return on the leading diversified emerging market debt (EMD) index has been fairly flat this year, as income has offset capital losses (chart 6). But emerging market currencies have been falling again. In sterling terms, currency depreciation has dragged index returns down by 30% in just over two years and cumulative total return has been negative over the last five. As we have noted before, momentum in foreign exchange markets can be persistent and it is easy to come up with reasons why emerging market currencies might weaken further. But those who see EMD as more than an opportunistic investment must surely expect long-term gains from taking currency risk. If they are not now thinking about adding to exposure, they should perhaps be reviewing their strategic rationale for investment.

CREDIT MARKETS







Not going out

The latest instalment of the Greek debt crisis served as another reminder that credit risk attaches to sovereign bonds that are issued in a currency the sovereign does not control. The possibility that Greece's problems might spread elsewhere in the Eurozone has been much debated in recent weeks, but chart 7 suggests that investors did not view it as much of a risk. This was never really viewed as a 2012-style existential crisis for the euro. The rise in the extra yield investors demanded on Spanish and Italian bonds relative to German bonds was modest and has already been largely reversed. The absolute yields on Spanish and Italian bonds are lower than equivalent US yields. However low the risk of a Eurozone break-up is thought to be, it is not a risk that many UK investors need to take. The current rewards are hardly sufficient to entice them to take it on a discretionary basis.

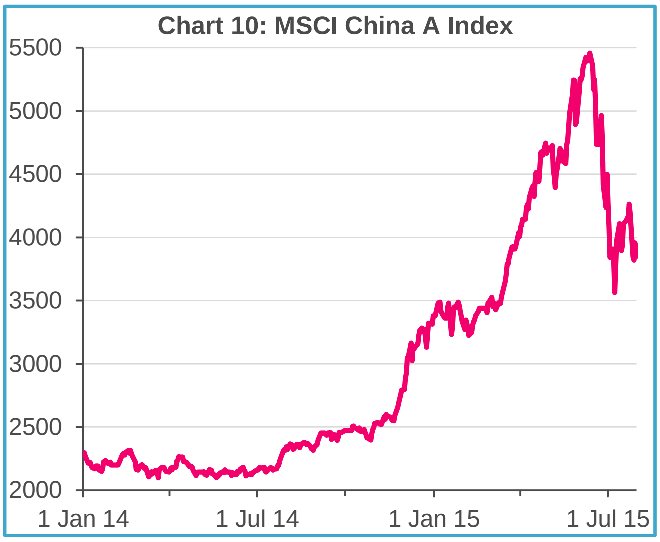
Opening credits

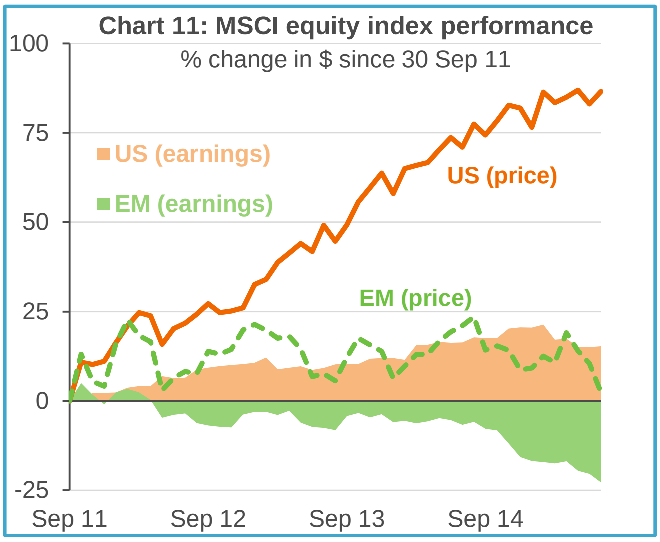
For most of the last two years, the yield spread on sterling investment-grade corporate bonds relative to gilts has been in a fairly tight range. The left-hand side of chart 8 hints at the higher rewards that have been available at times in the past. In the context of the recent range, there have been significant swings over the last twelve months. The latest has taken spreads from the low point of the range in early March to the high point at the end of June. High-quality corporate credit can be seen as a compromise … and not always a necessary one. In many cases, either the certainty offered by gilts or the enhanced income from wider credit markets will be more valuable. But where investment-grade credit does have a role to play, where both the need for return and tolerance of risk is low, exposure should now be in line with strategic targets.

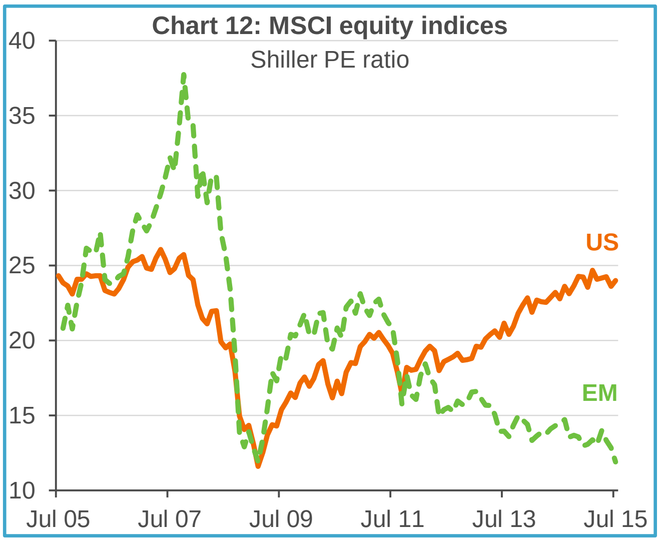
Closing credits

We have used the gap between the spreads available on secured loans and high yield bonds as a guide to the extra rewards available in credit markets for sacrificing a bit of liquidity in return for better covenant protection. In US dollar markets, the gap has closed considerably over the last year (chart 9). That is more about market structure – the high weight of the out-of-favour energy sector in US high yield – than anything more general: the gap remains wider in euro markets. This emphasises an important point – covenant quality matters more than the type of debt. Loans and bond indices illustrate broad characteristics, but not all loans have ideal covenants and there are plenty of secured high yield bonds. (Bonds do bring some duration risk, but usually not much.) Hence our preferred approach of combining these assets in one mandate, allowing managers to select the best opportunities wherever they arise.

EQUITIES







Wild China

A year ago, domestic Chinese equities, as measured by the MSCI China A Index, had fallen by a quarter in five years. The Chinese economic miracle had carried on regardless. Within a year, despite mounting concerns about the sustainability of economic growth, equities rose by 150% (chart 10). The economic consequences of the recent 30% plunge may not be significant. As domestic shares are largely off-limits to foreigners, there will be few direct consequences for global investors. There may be lessons from frantic official attempts to stabilise the market (a potential commitment of $350bn by some estimates), with mixed success so far. Controlling a stock market is difficult: can an entire economy be more tractable? The downward drift in trend GDP growth from 10% p.a. to 7% p.a. may have been accepted by the authorities. Whether they guided it or can control it from here, is another question.

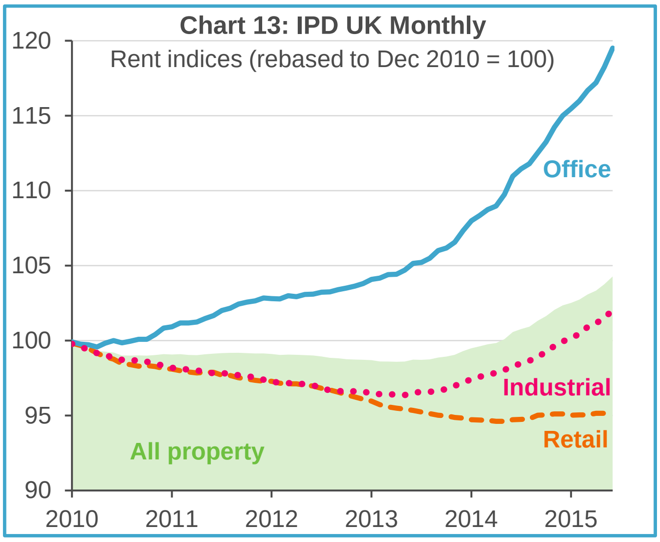
American X factor

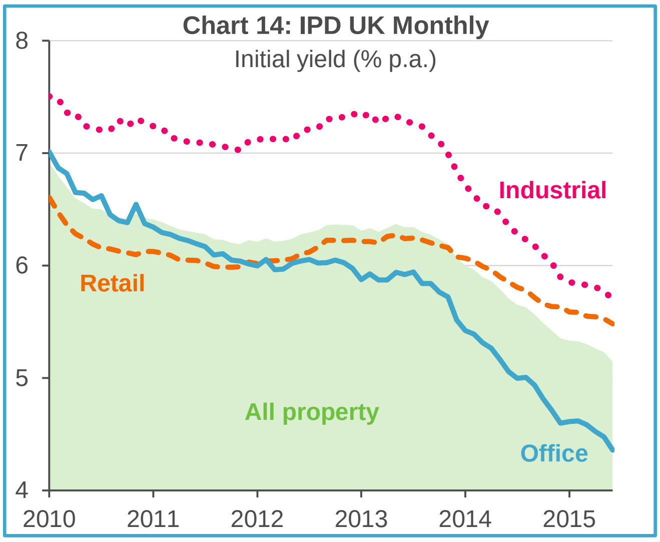
We have noted before that the rally in global equities from the last serious downturn in summer 2011 has been driven primarily by revaluation. This is also true at a regional level, although the absolute levels of price and earnings growth inevitably vary considerably – the US and emerging markets (EM) mark the extremes (chart 11). In both cases, prices (the lines) have risen much more than earnings (the similarly shaded areas). The US market has significantly outpaced a solid earnings performance that has only shown signs of weakness in recent months as a strong dollar and low oil prices take their toll. The MSCI EM index is barely changed in US dollar terms (dragged down by currency depreciation of 20%), but that is still well ahead of a fall in profits of over 20%. In terms of historic price-earnings (PE) ratios, both markets are a lot more expensive. We are less troubled by the move in EM than in the US.

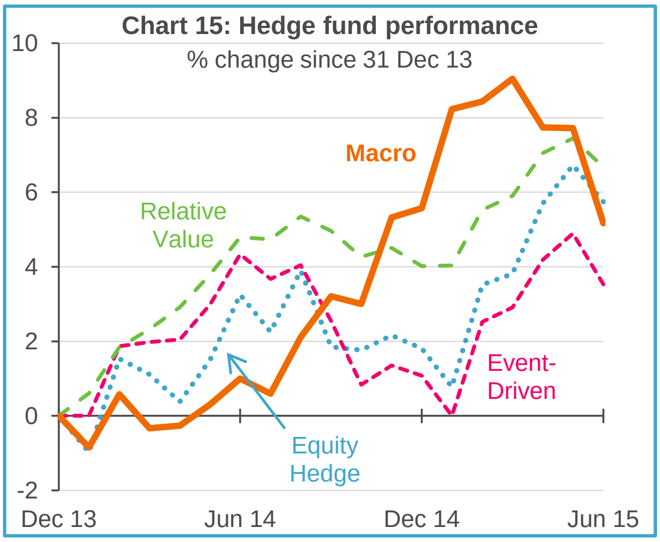
Next top model

Future returns from US and EM equities will be driven by dividend income (where EM has a yield advantage), trend earnings growth (we doubt the long-term US experience will be superior), the divergence of earnings from trend (our assumption is that US earnings are ahead of, and EM earnings below, trend) and revaluation. We can combine the last two components by calculating 'Shiller' PE ratios, which use the average real earnings of the previous 10 years as a proxy for the trend level (chart 12). Revaluation and movements in earnings relative to trend are frequently the biggest drivers of medium-term returns from equity markets. Looking beyond the current travails of EM and the recent track record of the US, we would expect better returns from the market valued as cheaply as it has been for 10 years than the one that has rarely been more expensive.

OTHER INVESTMENTS







Office appraisal (I)

The start of the current rally in UK property coincided with the end of the downward drift in aggregate rent indices, which are now some 5% higher than they were two years ago (chart 13). But the overall rise conceals divergent sector performance: retail rents have, at best, stabilised in the last year, while office rents have been rising for over five years and are 20% above their lows. (That reflects strength in London, which dominates institutional investment in offices.) The comparison is perhaps a little flattering to offices, which are the most cyclical sector in UK commercial property. The IPD Monthly office rent index is still no higher than at previous peaks in 2008 and 2001. There is little sign yet of any loss of momentum, but we rather doubt that the sector's cyclicality is a thing of the past. Our assessment of offices would assume that rents are already ahead of trend rather than setting off on a higher one.

Office appraisal (II)

This assumption may not be widely shared. The initial yield (i.e. calculated from income actually received) on offices has slipped well below the market yield (chart 14). On that measure, the relative valuation of offices is more demanding than it has been in the last 30 years. Admittedly, that ignores the reversionary potential in offices – the expected rise in income as higher rents are crystallised by future reviews and the letting of void properties. (It is interesting in this regard that, despite rental strength, voids in the office sector have risen since the end of 2009, while they have fallen elsewhere.) But, even after adjustment for reversion, office valuations look stretched, with little cushion to absorb any reversal in rental growth. Property strategy cannot be changed overnight and the characteristics of an individual building can be as important as its sector, but a bias to reduce office exposure seems increasingly appropriate.

Detrended

After several lacklustre years, macro hedge funds finished 2014 strongly (chart 15). This was not too surprising when global equities were going nowhere. Macro funds consistently exhibit a lower correlation to equity markets than is typical for other strategies. We noted at the start of this year that strong trends in the US dollar and bond yields might have proved very helpful for macro funds. And performance did turn down as the rise in the dollar tailed off and bond yields started to rise. Other major strategies fared better, at least until global equity markets started to drift lower. All hedge fund investment comes with warnings about costs and the difficulty of manager selection. Macro funds may not have fully proved their credentials after the credit crunch, but we still prefer them to alternatives that do not offer much diversification from equities.

MARKET RETURNS 2015 (%)

UK	July	Q2
EQUITIES	2.4	-1.6
BONDS		
Conventional gilts	1.6	-3.4
Index-linked gilts	2.7	-2.7
Credit	1.5	-3.9
PROPERTY		3.6
STERLING		
v US dollar	-0.8	5.9
v Euro	0.1	2.1
v Japanese yen	0.5	8.1

	Local currency		Sterling	
OVERSEAS	July	Q2	July	Q2
EQUITIES				
North America	1.9	0.1	2.5	-5.4
Europe ex UK	5.3	-3.9	4.6	-5.9
Japan	1.8	5.6	1.3	-2.3
Developed Asia ex Japan	0.1	-3.1	-2.3	-8.3
Emerging Markets	-4.9	2.2	-6.1	-3.7
GOVERNMENT BONDS	1.3	-2.7	1.4	-7.2
HEDGE FUNDS *		-0.5		
COMMODITIES *	-11.4	6.7		

** Local currency = $*

SOURCES

CHARTS

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

TABLE OF MARKET RETURNS

Datastream – indices as shown below

Equities	
UK	FTSE All-Share
Overseas (developed)	FTSE World indices
Emerging Markets	FTSE All-World Emerging Markets
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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