

# Market Commentary

Q1 2014

The first quarter of 2014 held some big surprises for many market participants. The general consensus at the start of the year was that equities would do better than bonds and that gold would continue to fall towards USD1000. In fact gold has performed the best of the three assets rising 10% by mid-March and currently 6.5% higher than the start of the year. Equities ended the quarter up 1.4% mostly due to the last few trading days but had fluctuated around the breakeven mark for most of the quarter. There were bouts of volatility brought about by disappointing US and Chinese economic indicators, the Ukrainian turbulence and Janet Yellen's speech. Bonds much to the surprise of most investors were up 2.5% for the quarter. Therefore, the asset class expected to do best fared the worst and vice-versa. It must be noted however that the situation at the end of January was much more extreme as equities had fallen 1.7% and bonds had rallied 3.4% (Fig1). The spread between equity and bond performance has narrowed from 5.1% to 1.1% in just two months.

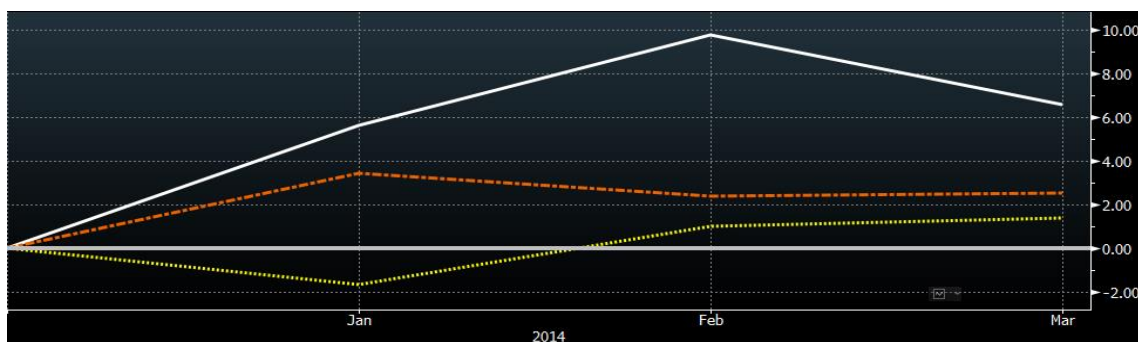


Fig1. Year-to-date performance of Gold (white), Bonds (orange) and Equities (yellow).

Source: Bloomberg

## Bonds

We had mentioned in earlier reports that we favoured emerging market bonds issued in USD and EUR over high yield corporate bonds in Europe and the US as we felt they offered better risk adjusted returns. As can be seen from the graph below, emerging market bonds have performed better than high yield bonds and the trend seems to be gaining momentum (Fig2).

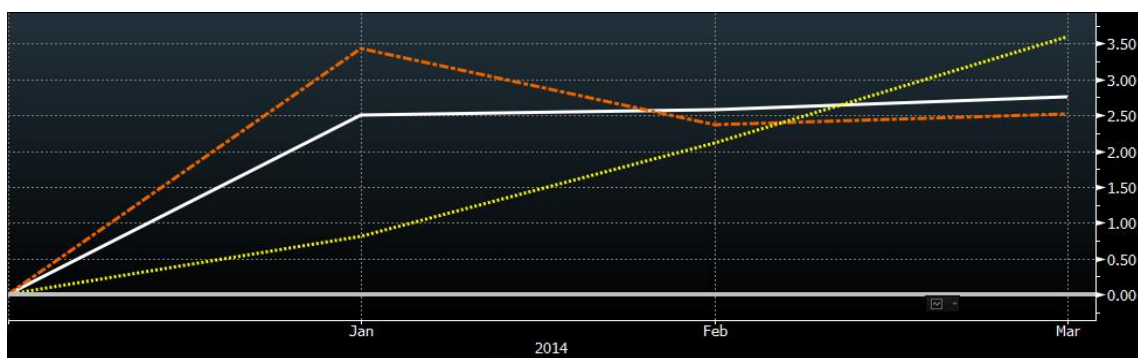


Fig2. Year-to-date performance of High Yield (orange), Global (white) and Emerging market (yellow) bonds.

Source: Bloomberg

We also indicated a preference for Norwegian Kroner, Australian and Canadian dollar bonds of the same duration over their Euro or Swiss counter parts. They offered a higher yield for the same maturity and the potential for currency appreciation as well. The Norwegian Kroner has risen about one percent versus the Swiss Franc and the Euro this year and the Australian dollar has rallied more than 3%. The laggard so far has been the Canadian dollar which has continued to fall versus both the Euro and the Swiss Franc.

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However, the recent economic indicators from Canada lead us to believe that the Canadian dollar will soon start to strengthen as well.

## Equities

At the start of this year we were expecting European equities to perform better than their US counterparts and emerging markets to do better than most market participants were expecting. As can be seen from the graph below European equities outperformed US equities for most of the quarter and have ended the quarter ahead by almost a percent (Fig3). Emerging markets lagged badly for most of the quarter but have staged a very strong rally in the last two weeks.



Fig3. Year-to-date performance of European (white), US (orange) and Emerging market (yellow) equities. Source: Bloomberg

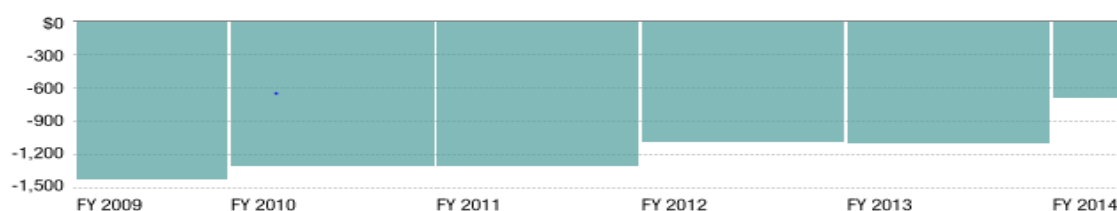
We mentioned in earlier reports that the key to these markets stabilising and rallying lies with China. Though news out of China for most of the quarter caused a lot of concern amongst investors, there has been a stabilisation in recent weeks as the Chinese government has indicated that infrastructure and other focused spending will be accelerated to support growth and employment. The Indian equity market has performed well as a result of the reduction in the current account deficit and inflation as well as the hope associated with the upcoming elections. Even Brazil and Mexico, which had been laggards, have staged very impressive rallies recently as valuations are compelling and political changes are expected in Brazil while recent reforms in Mexico seem to be paying off. This is a good sign and similar to the behaviour of the US markets in 2009 and the European markets in 2011 when additional bad news did not seem to have as much impact and tiny bits of good news caused markets to rally. Most investors are extremely underweight emerging markets and any rally from current levels will be exaggerated due to short covering and benchmarking of positions.

European macro data has been steadily improving over the past two to three quarters and should start feeding through to company earnings over the rest of the year. Operating margins are below their ten year average and it is our opinion that the trough has probably been reached and that improvements in margins followed by revenues lie ahead. Revenues would be boosted by a weaker Euro and the ECB is very aware that the weaker Euro would also help support inflation. It is a concern for most European producers that Euro strength is weighing on their competitiveness versus the US and more recently Japan. Germany and Japan compete for sales in many segments of the export market and if the current foreign exchange situation prevails or worsens, this could prove to be a significant issue for German exporters.

In the US even though quantitative easing has been reduced, it is still at very high levels and its effectiveness has been vastly improved by the recent increase in the private sector velocity of money in the US. Employee confidence has been rising and companies are starting to consider increasing investment according to the latest surveys. Though private velocity of money has increase over the past

two quarter the headline number has been subdued due to the contraction in government spending. Federal and state deficits had reached precariously high levels after the crisis and spending cuts had to be implemented (Fig4). Last year due to a rise in tax revenues in addition to spending cuts, the deficit has halved and is expected to shrink further over the next couple of years. As a result, the government could be encouraged to invest in much needed infrastructure renewal which would increase the headline velocity of money which is what all the quantitative easing was aimed at achieving. This uptick would be a boom for engineering companies, resource producers, technology firms and other capital goods providers. All of these developments and the resulting increase in capacity utilisation should lead to an uptick in inflation which would provide additional support to the gold price.

**The federal budget deficit (in billions)**



**The federal budget deficit as a percent of GDP**

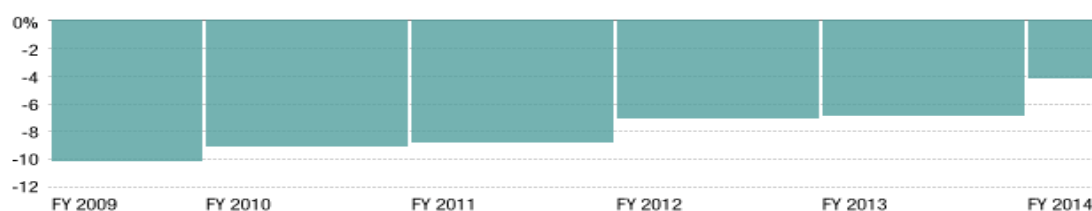


Fig4. US Federal Budget deficit

Source: Sunlight Foundation, White House Office of Management and Budget

## Commodities & Gold

As we were expecting all of the developments in the US and Europe outlined above, we were more positive than the consensus on mining companies and gold at the start of 2014. So far our position has paid off. We have participated in this move with holdings in gold and gold miners as well as BHP Billiton and an ETF concentrating on the sector. We were of the opinion that too much pessimism was priced into mining shares and that they had substantial capacity to implement self-help measures which would be very investor friendly. BHP Billiton and Rio Tinto have announced several measures to reduce capital expenditure and boost shareholder returns. The recent indications from China that they will speed up infrastructure spending have been supportive of commodity prices which had experienced a setback in March after a strong rally earlier in the year. Iron ore is up 10% from its lows and copper has rallied 5%. Soft commodities have rallied strongly with corn, wheat, coffee and sugar up 10-50% last quarter. Each commodity has risen for different reasons, some geo-political, some weather related but all leading to supply constraints in the near future.

Gold has been boosted by stronger physical demand coupled with net inflows into ETFs for the first time since 2012. The Reserve Bank of India has recently indicated that they will be considering reducing restrictions on gold imports into India. They have already loosened limits on banks importing gold and other measures are being considered. There is substantial pent up demand in India for gold as these restrictions and taxes have been in force for almost three quarters. As Indian demand returns to the gold market, the price of gold is expected to rise further. This in turn might attract inflows into the gold ETFs and boost gold prices, which is the opposite of what happened last year.

## General Thoughts

The IMF has been persistent in urging more co-ordinated efforts to boost global growth which five years after the financial crisis is still at levels that are way below average. There have been several remarks directed at Europe encouraging the use of unconventional measures to support growth. ECB President Mario Draghi at his latest press conference said that the Governing Council was unanimous that it would use unconventional policy within its mandate including quantitative easing when considered necessary. This statement caused the Euro to weaken versus all of its major counterparts except the Swiss Franc. We believe that if this trend continues and an exchange rate closer to 1.35 to the dollar or lower is achieved, European companies will benefit substantially especially the companies which are more cyclical in nature. Some cyclical winners in the portfolio this year have been Potash (+9%), Holcim (+12%), Larsen & Tubro (+19%) and Microsoft (+10%).

The velocity of money in the US appears to be ticking up as Quantitative easing is winding down. The ECB has for the first time stated clearly that it is willing to support growth and curb deflation using all tools conventional and unconventional at its disposal. This relative move should strengthen the US dollar and weaken the Euro. The Japanese are determined to achieve their inflation targets through continued stimulus and the Chinese have announced measure to support domestic growth and employment. Put together, this is the most favourable background for co-ordinated global growth we have had in any year since the financial crisis. However, due to the strong rally especially in the US last year, many stock prices already reflect a lot of this good news and some are at levels reflecting over optimistic forecasts in our opinion. It is therefore important to sift through regions and sectors to look for those stocks that have been neglected in last year's rally and should benefit substantially from their operational leverage and low valuations going forward. We believe we have several of these stocks in client portfolios and are in the process of adding to holdings as opportunities arise.

Gillian Hollenstein

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