

Market Commentary

June 2014

There have been some important developments since our last report which have changed the backdrop for financial markets. Though we are aware that the continuing turmoil with regard to Ukraine and the recent events in Iraq could have a large impact on investor risk appetite, we will focus on macro-economic and monetary policy issues in this report.

In our opinion even though many market participants have become used to disregarding inflation, it has just become an important topic once again due to recently published US inflation figures. The FED spent most of last year worrying about very low inflation and the threat of a return to deflation. However, the latest inflation numbers show that both, headline and core inflation, are about 0.2% ahead of the FED's projections and are already at levels expected at the end of this year or early next year. On the other hand new home sales and employment numbers show less strength than hoped for. The market believes that as the FED has emphasised the importance of employment numbers with respect to monetary policy changes, there will be no change in the schedule for stimulus reduction. While this might be true for the moment, we believe that inflation will now be closely watched for any sign that a trend is being established which might force the FED to increase rates earlier than originally expected. Recent comments from the Bank of England also imply that interest rates might have to be raised earlier than expected in light of economic improvements and in order to avoid the formation of bubbles.



Fig. 1 Eurozone inflation from July 2007 – May 2014.

Source: ECB

In complete contrast we have the ECB rolling out a series of measures aimed at supporting growth and avoiding deflation. As Mr. Draghi is aware that a weaker currency is the quickest way of achieving both goals, there is a clear focus on weakening the Euro. Investors were disappointed with the way the Euro reacted to the ECB's monetary policy package on 5th of June. It dropped immediately after the package was announced and then started to rally, ending the day higher than it was before the announcement. We believe that much of the weakening in the Euro took place in anticipation of the monetary policy announcement and from current levels progress will be more moderate. We are of the opinion that if current measures do not contain Euro strength, there will be more measures announced later in the year, until the goal is realised. Though most market participants were not expecting the ECB to stop the sterilisation of the Security Markets Programme (SMP) portfolio, we were of the opinion that this was an important part of the package and are pleased that they have made this announcement which will lead to an injection of about EUR150 billion of liquidity into markets. As the ECB has simultaneously introduced a negative deposit rate, it is discouraging banks which were holding reserves beyond the requirements with the ECB. As there is insufficient demand for credit within the Eurozone to absorb all the excess reserves in the system, we believe that money will gradually start to flow towards non-Eurozone countries and will weaken the Euro further. This move should be supported by the fact that both the bank of England and the FED will be in relative tightening mode while the ECB is in relative easing mode going forward. In order to incentivise banks to lend to the private sector the ECB has announced the Targeted Long-term Refinancing Operations (TLTRO). Collateral requirements have been eased and very favourable interest rates applied to make the scheme more attractive. In our opinion, the effectiveness of this scheme which starts in the third quarter of 2014 will only be evident three to four quarters later.

Bonds

An interesting observation is that two years ago in June 2012 the US 10yr treasury was yielding 1.5% and after rising above 3% has fallen back to 2.6%. However, during the same period yields of Spain and Portugal have fallen from 7.7% and 11.3% to 2.6% and 3.5% respectively. Therefore Spain which is BBB rated is trading at a similar level of implied risk as the US with a AAA rating at the moment. Additionally, as the yields of Spain and Portugal have fallen the 10yr yield of the US has risen. Therefore, the US treasuries might look more attractive to investors than they did two years ago compared to those of Spain and Portugal. Moreover, versus Germany (AAA 1.34%) and France (AA 1.79%) the US (AAA 2.6%) looks attractive as well, especially if the EUR stays at current levels or weakens. The UK (AAA 2.7%) and Norway (AAA 2.5%) also look more attractive than Spain, Portugal, France or Germany on a risk adjusted basis. Though it is true that interest rates in the US, UK and Norway are likely to rise either later this year or early next year while European interest rates rise much later, we believe the risk adjusted returns still look superior for the former at current levels. We are not recommending the purchase of any of these ten year bonds but simply pointing out that we believe the bond market in Europe has gotten ahead of itself.

Investors seeking yield have been forced into taking on risk and buying high yield and Spanish or Portuguese bonds. As spreads have narrowed drastically the yields on these higher risk bonds are now lower than the dividend yields of many large cap European companies. We believe that this fact will prompt investors seeking yield to increase exposure to the higher yielding equities with solid balance sheets as the risk/return estimations are now attractive when compared to high yield or periphery bonds.



Fig. 2 YTD performance of Emerging market (white), High Yield (orange) and Global (yellow) bonds. Source: Bloomberg

This year 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, and as can be seen from the figure above, the past quarter has been an excellent one for emerging market bonds bringing their total return year to date to 9.4% whereas global bonds and high yield bonds produced a total return of about 5.7% (Fig. 2). After the recent outperformance we have reduced positions and booked profits.

The important point to note is that despite the higher risk and volatility associated with the high yield bonds, they have not performed better than the average global bond index and underperformed the emerging market bonds.

We remain underweight US and European bonds with average durations at 3-4 years and slightly overweight emerging market bonds issued in USD and EUR and hold Norwegian Kroner, Canadian Dollar and Australian Dollar bonds for our clients.

Equities

At different times during the first half of the year, US, European and Emerging market equities took turns in outperforming. At the end of the second quarter as can be seen from Fig. 3, all three are at similar levels. However Europe has performed better for most of the first half as expected and the Emerging markets have rallied strongly in the second quarter.



Fig. 3 YTD performance of European (white), US (orange) and Emerging market (yellow) equities. Source: Bloomberg

We were expecting EUR/USD levels of about 1.35/1.36 leading up to the June actions from the ECB. This level has been reached and there seems to be a period of sideways movement at present, before the next leg down. Achieving EUR/USD levels at or below current levels is very important to the ECB as the foreign exchange effect has been the main factor mentioned by the majority of European companies reporting results that were less favourable than expected. Even those that produced good results mentioned that their earnings would have been far better had the Euro not been so strong. The ECB is acutely aware of the necessity to boost GDP growth from current levels of well below 1%. A weaker Euro would support earnings, increase the competitiveness of European exporters and also cause a rise in inflation which is well below the ECB's target at the moment. This triple benefit from a weaker Euro would be more than welcome and therefore fully supported by European politicians as well. Moreover, a weaker Euro should have a positive effect on European exporter earnings and margins and would therefore imply a rally in stocks which have suffered last year from the strong Euro.

We have been monitoring the increase in capacity utilisation and improvement in the labour market in the US as leading indicators for higher projected inflation. The recent inflation reports out of the US support this view as inflation is higher than the FED was expecting. The Fed has already slightly raised the expected level of interest rates for the end of 2015 and 2016. The US bond market reacted by pushing yields higher. However, equity markets took the numbers in their stride and chose to concentrate on the fact that the higher inflation was a result of positive developments in the economy. The implication that the FED might need to raise interest rates earlier than expected did not seem to bother equity market participants. However, if inflation continues to rise from these levels, the FED might be forced to alter its schedule and this could cause volatility in equity markets later in the summer or in early autumn. We would therefore avoid interest rate sensitive sectors like utilities and concentrate on sectors like industrials and technology which should benefit from increased capacity utilisation as well as infrastructure spending. We have been accumulating these positions whenever the market showed weakness over the past six months and will continue to use opportunities to add to existing positions.

As a result we remain underweight US and overweight European and Emerging market equities. We have built Japanese equity exposure during the recent consolidation and reduced exposure to India after the election induced strong rallies. Some equity winners in the first half of 2014 have been Potash (+18%), Microsoft (+13%), Intel (+20%), Holcim (+18%), Novartis (+16%), Zurich (+10%), Shell (+20%), ENI (+17%), Unilever (+11%) and Larsen & Toubro (+65%).

Commodities & Gold

After a very strong first quarter, gold and commodities experienced a setback in the second quarter of 2014. We are more positive with regard to the larger commodity companies as we believe that they have implemented a lot of efficiency measures and capital expenditure reductions which will benefit shareholders. BHP Billiton and Rio Tinto offer dividends in excess of 5 % which could rise further as free cash flow increases due to the above mentioned measures.

After dropping back from around the USD 1400 mark to below USD 1300, gold seems to have formed a base from which to rally further. The summer is usually a good time for a gold price rally and we believe this year will be a repetition of this pattern. We have seen gold rallying in summer even in a weak year like 2013 and this has been true 9 out of the past 10 years. In our opinion support for gold demand should be provided by the higher than expected inflation figures out of the US and increased demand from Indian consumers if import restrictions are reduced as expected.

The latest World Gold Council Gold Demand Trends report, which covers the period January-March 2014, shows a return to the long-term quarterly average demand trends established over the past 5 years. Global demand for jewelry, the most significant component of overall demand, totaled 571 tonnes in Q1 2014, a 3% rise on the same period last year, representing the strongest start to the year for jewelry since 2005. Most notably, there was a 10% rise in demand for jewelry in China, which became the largest global market for gold demand in 2013. Central banks continued to be strong buyers, purchasing 122 tonnes in the quarter. This is the 13th consecutive quarter in which central banks have been net purchasers of gold and indicates their continued commitment to diversifying their assets. These factors coupled with the discrepancies pointed out in our last report should result in strength in the price of gold with some bouts of volatility.

General Thoughts

We believe that market participants will continue to chase yield, and due to several factors mentioned in this report, they should find the larger exporters in Europe attractive. The Bond market in Europe should consolidate after the recent rally as the yields on lower grade bonds appear to be too low compared to bonds of higher grade issuers. The ECB initiatives should support the European equity markets more than bond markets from current levels and the US FED continues to communicate actions that the market sees as favourable. European stocks have been lagging The US in performance since the financial crisis and we believe that the gap will start to close. Gold should rally through the summer.

Gillian Hollenstein

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