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VIEWPOINT

Viewpoint

October 2014

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Experienced, professional and trusted; Rayner Spencer Mills Research is an independent company established in 2004. After many years working in the financial services market, we felt that the rapidly changing environment presented a unique opportunity to set up our own company to deliver quality independent research and ratings. Our work, whether for advisers or providers is made with total impartiality and without any conflict of interest.

Working across the whole financial services marketplace we deliver specialist research, analysis and support to a diverse range of financial advisers and planners helping them to ensure they deliver sound advice to their clients backed by rigorous and structured research and due diligence.

In addition, our fund ratings are now recognised as the 'badge of quality' when selecting funds.

We also work with all the leading providers across the financial services sector offering our straight forward and pragmatic advice to help fund groups, life and pension companies and platform operators add value to improve their business performance and efficiency.

We understand financial services and we will work alongside you to deliver tailored solutions that are right for your business and your clients.

Introduction

Welcome to Viewpoint – helping advisers gain a better knowledge of the economic environment and markets.

Viewpoint comprises this quarterly investment bulletin with its wealth of data and commentary on the last quarter plus a short video featuring one or both of our Investment Directors – Ken Rayner and Graham O'Neill – who will highlight the key points and summarise their views on the outlook for the quarter ahead.

This combined approach provides the level of detail you need to ensure you are fully briefed on the current global markets allowing you to provide context to your client's investments.

We see Viewpoint playing an important part in your continuing professional development (CPD) requirements by:

- building client confidence in your ability through your understanding of the financial markets
- updating your skill set and knowledge
- reinforcing your professional credibility.

The FCA requires that you should complete 35 hours of CPD annually in order to retain your Statement of Professional Standing (SPS) and by working with Asset tv you can automatically record your CPD alongside viewing the video with a transcript of the video available for reference plus this detailed Viewpoint bulletin.

Viewpoint is part of the expanding services available to advisers from RSMR and we hope you find this a valuable addition as you enhance your professionalism.

We have a range of independently produced material which is available via our website – rsmgroup.co.uk – and go to tabs at the top right to Register or Login.

Watch the video on our Rplayer at www.rsmgroup.co.uk/ratedfunds/watch-tv/

Rplayer

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General Economic Overview Q3 2014

The third quarter of 2014 has left us with a mixed picture of economic data and market direction after a period when both bond and equity markets have seen some positive gains. Surprisingly we have seen the gilt market produce strong returns after a period when most fund managers had expected the increasing pressure on central banks to increase interest rates, leading to a rising yield environment. This has not been the case as the threat to near term interest rate rises has receded and geopolitical events have led to the continued support of western government debt. The continued bond buying by central banks has also acted as a backstop to market demand reducing. One of the aims of QE was to support asset prices and this has been effective, particularly in the US. To a certain degree this has led the market to front run the economic data, and prices for companies can be generally thought of as either overvalued or fair valued but certainly not cheap. There is selective value in individual stocks and some sectors but the opportunities are limited unless we see more economic evidence that earnings are improving at a greater rate than at present.

The ending of QE is likely to cause volatility but not in the way that we saw when it was first announced in May of last year. Whilst US treasuries will have to find new buyers, other economies such as Europe and Japan may step in to aid global liquidity. The US central bank does not want to over tighten in this environment so interest rate rises still look some way off in the US, but more likely in the UK. The threat of a policy mistake in this environment is more likely given the tools available are still quite blunt. It is likely however that the next move in rates will be upwards and the question for the equity market is whether this will cause a modest re-rating from which markets can recover off the back of gradual gains in profitability. If this is the case then we are likely to see a slow growth environment for some time to come.

Inflation, another area of concern, has generally been subdued, helped by the slow increase in wages despite an improvement in employment numbers across western markets. In some ways the threat of deflation has increased, particularly in Europe, which has seen some additional measures put in place to counteract this influence.

There are not yet the obvious imbalances to bring this current economic upswing to an end. Inflation is not yet a problem anywhere in the world, so there is no real necessity for Central Banks to tighten aggressively with the aim of slowing economic activity. Current account imbalances have improved in recent years, especially in the States. Although there is talk of bubbles, there is no real sign yet of clear financial excesses, with even government bonds supported to some degree by the likely lower level of Central Bank interest rates during the current cycle peak. Corporate earnings look set to grow in the region of 5%-10% and there has been repair to the banking system, even in Europe. In the States the strength of the banking system is allowing lending standards to ease, helping the SME sector.

Overall the central case is for the recovery in the global economy to continue into 2015 and 2016, although the pace of this is likely to remain uneven. This does of course assume that there is not an external shock.

Equity Markets Overview

Chart showing 2014 returns for major market indices:

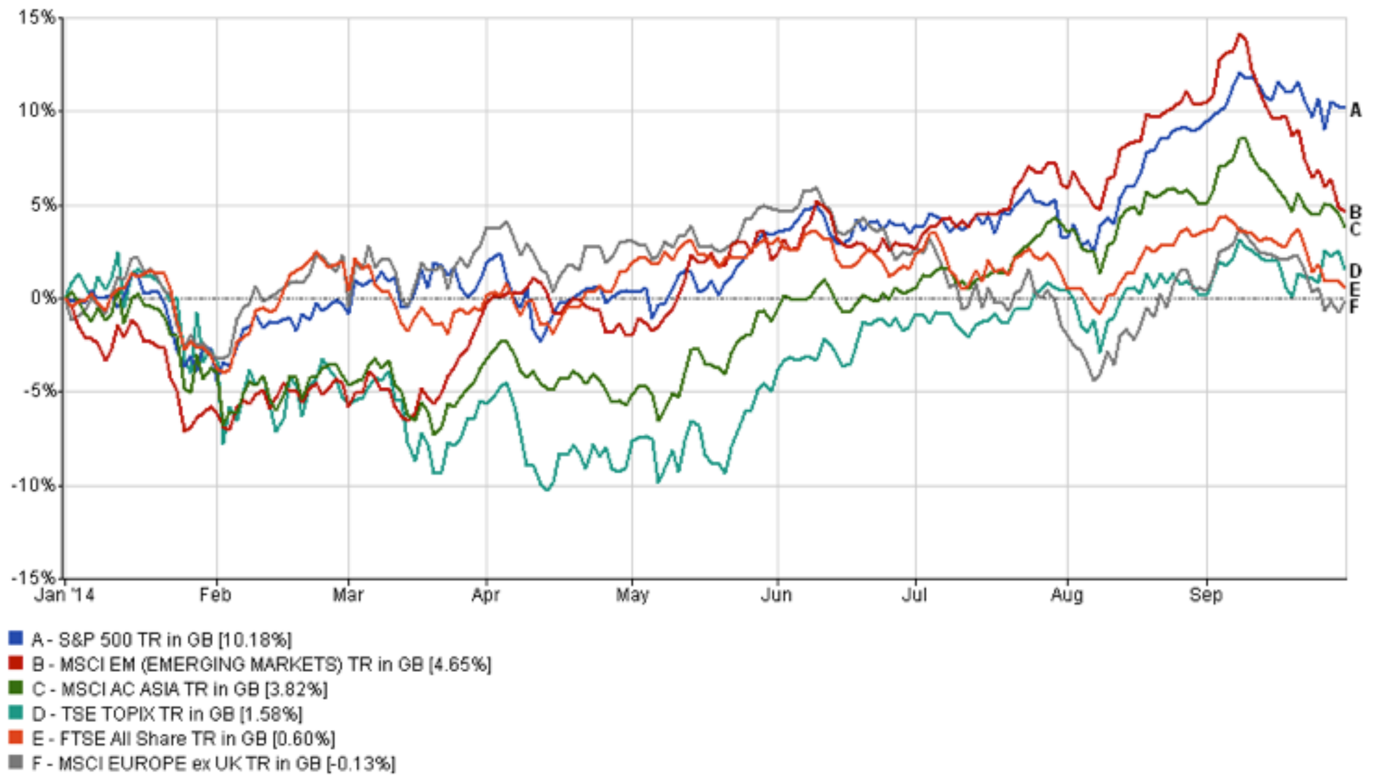
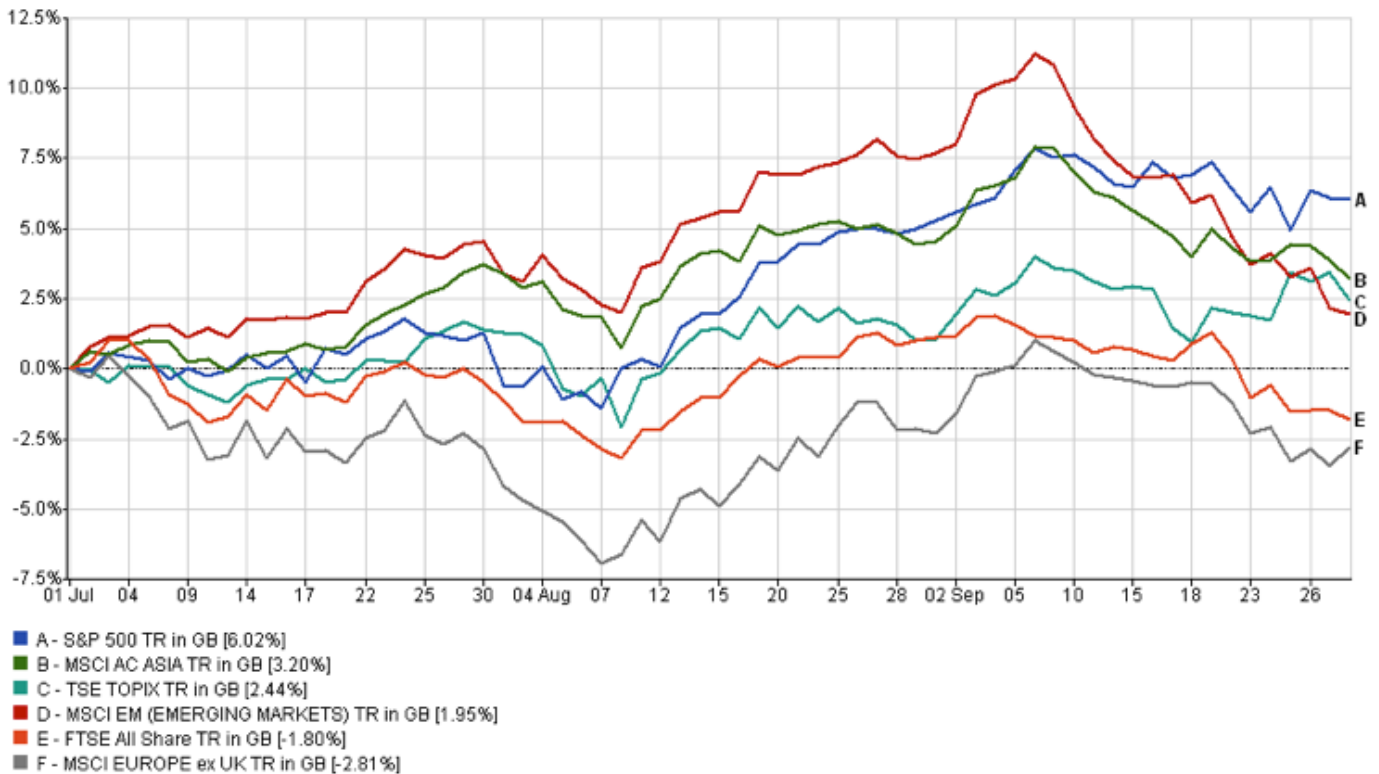


Chart showing quarter three returns for major market indices:



Equity markets seem to have paused since the first quarter of 2014 and we have seen a rotation away from the momentum of the mid and small cap rally, returning to the more value driven large cap stocks. One of the factors holding back markets, other than earnings growth, has been geopolitical risk which has been seen in a number of areas the latest of which has been in Hong Kong where demonstrations against Chinese influence on policies has recently broken out. The Middle East and the problems in the Ukraine continue to cause uncertainty for investors. Much of this can be seen to be priced in but markets would be sensitive to any further escalations in any of these conflicts. One can probably conclude that market volatility will increase over the next few quarters given these factors and the fact that equity volatility indices have been low for an unusually long period. The weakest markets are those where the greatest uncertainty still exists - areas such as Europe and Emerging Markets.

Looking ahead, the best outcome for markets will be 'Goldilocks' US growth, something not too hot, neither too cold. In the short term markets will be concerned about what is likely to have the biggest influence on equities – a modest contraction in PE ratios or earnings growth. In other words can profit growth outweigh a modest de-rating of markets if bond yields and short term interest rates rise? If the expansion proceeds at a moderate rate, and inflationary pressures are contained, today's higher valuation levels are more tolerable, because interest rates while rising, will remain low by historic standards.

UK

The UK economy is one of the strongest globally in 2014 with the growth in GDP higher than most western economies. The economic data continues to be relatively strong with Q2 GDP confirmed at 0.8% (3.2% annualised), the Bank of England revising up its 2014 and 2015 forecasts and PMI data remaining relatively strong across the sectors. This continues to raise questions as to when interest rates may begin to rise and the August Monetary Policy Committee interest rate decision was split for the first time in a long while.

The unemployment rate continues to fall but wage inflation remains weak, causing a conflict about the future direction of inflation, which fell to 1.6% in July having risen to 1.9% in June. Market valuations are not overly stretched but not cheap either. Companies in the FTSE 100 index look reasonably attractive at current valuation levels versus history and versus mid-caps and smaller companies given the strong returns from the latter categories over the last couple of years. Large caps have outperformed year to date despite them being more influenced by the relative strength of sterling given their greater proportion of overseas earnings.

US

In the US the market has been extremely strong but recent events have combined to leave investors confused as to which way the next big move will be. Whilst the global economy continues to heal, US shares have had a significant climb of around 180% since 2009. This means the US bull market has lasted for 5 years, which is longer than the average, and there has been no 10% correction for 3 years. Market leadership has become increasingly narrow, with small caps significantly lagging the S&P 500 this year. US high yield debt has shown signs of breaking down lower and both high yield and US small caps were early warnings of trouble in both 2000 and 2007.

More fundamentally ultra-easy monetary policy, a key support to asset prices, is weakening. In the US and UK this is definitely now reaching the end of its stimulus period as QE in the States is scheduled to end in October, which means that treasury bond issuance will now have to be absorbed in the market. At least one objective of QE has been highly successful which was to raise the level of asset prices.

For many on 'Main Street' the strength of equity markets since 2009 is likely to have come as a surprise, however equities always respond favourably to easy monetary conditions, ahead of improvements in the real economy and this once again has been the case. The nature and extent of the easing, which has seen zero real interest rates in most developed economies, together with QE, has pushed equity prices higher than might have been the case in a typical economic cycle. With an early market re-rating, PE ratios have been higher than what one might normally expect, so at the very least market returns to investors are likely to have been front loaded.

Europe

The weakest of the western economic areas continues to be Europe. After some recovery in asset prices Europe has struggled in 2014. The situation is however mixed with Spain, Ireland and Germany seeing much stronger growth than countries such as France and Italy. Both Spain and Ireland are seeing the benefits of reform, whilst France and Italy remain hamstrung by political impasse. Economic growth data remains disappointing with the initial Q2 GDP estimate showing a flat figure that included negative growth from Germany and no growth in France, the two main economies.

PMI data remains in expansionary territory but the numbers have been weaker recently and differences remain between the individual countries. Inflation – deflation in particular – is the biggest short-term concern with August's flash reading showing a further fall to 0.3%, a 5-year low. The European Central Bank has intervened through a number of monetary policy measures, including new LTRO and ABS purchase schemes that are due to start shortly, but these may be insufficient and further measures may be introduced over the coming months if inflation remains a problem. With deflation a possibility in Europe the ECB has to take actions that supports the weakest areas even though this may not be needed across the whole region – this may lead to more aggressive monetary policy in the form of more formal QE if it is needed.

Asia

The markets in Asia have recovered somewhat from the beginning of the year along with the general recovery from the taper tantrum period in early 2013. India and Australia were the best performers with China and Hong Kong lagging this time. With Chinese Q2 GDP already coming in at an annualised 7.5%, which is the government's target, India followed with its highest quarterly GDP for 2 years with an annualised 5.7% and the new government has stated its intention to increase economic growth levels back to their previously high levels and has already started to introduce policy measures to help with this.

China's continued rebalancing to greater domestic consumption is widely expected to result in lower economic growth levels than in the past, there may be short-term fluctuations but it should lead to a higher quality of growth over the longer-term, although this potentially has significant consequences for other countries within the region.

The new leadership in China under Party Secretary and President Xi is focused on reform – Xi has rapidly consolidated his power base and gained control of the military at an early stage. The level of anti-corruption measures in the country are unprecedented and although some political rivals have been felled, there is genuine progress too with the result being that the credibility of the Party is improving. Main incomes continue to rise for the bulk of the population, but some second incomes are under pressure. An end to corruption should see better returns to shareholders, even as economic growth slows. Under President Xi and Premier Li Keqiang the private sector will become the driver of growth in China. A free trade zone has been set up in Shanghai and the so-called 'through train,' or Hong Kong Shanghai Stock Exchange, Connect as it is called is due to come into force in October.

Urbanisation will remain a key economic driver, and although the private housing market is showing signs of weakness, the number of social housing starts is increasing rapidly and likely to provide a higher quality rented sector for Chinese citizens. The new administration have already begun the

early stages of Hukou reform, allowing urban residency to country migrants if they have been living in a city area for a number of years.

Emerging Markets

Emerging markets have underperformed the global equity market by a significant margin over a 5-year period but with economic growth levels that are still higher than western developed markets overall, emerging markets equities have the opportunity to make up some of that performance differential. This is arguably an attractive entry point for the longer-term investor to access countries with higher levels of economic growth, although the opportunities are arguably more idiosyncratic in nature with country and currency selection becoming more important. Companies must demonstrate the ability to generate earnings growth in order for markets to move forward and the concerns about global withdrawal of liquidity (QE tapering, higher interest rates) are unlikely to dissipate over the short-term. Countries with current account deficits are likely to remain under pressure if there are no demonstrable plans for tackling more structural problems. More recent months have shown better data as the shorter term market numbers illustrate as investors have accepted lower levels of US QE.

One of the most important events in 2014 has been the election of Modi as Prime Minister of India. He has the potential to unlock the Indian economy with the first single party parliamentary majority for 30 years. If reforms are enacted India has the potential for this level of growth to be sustained over the next decade. Indonesia is another significant growth opportunity for the region now that president Jokowi has been elected. To succeed the new administration needs to build a manufacturing base for a country with a vast resource of cheap labour. Jokowi's biggest challenge will be to reduce corruption in the country which has been an impediment to investment and progress for many years.

Chart showing 2014 returns for major fixed income indices:

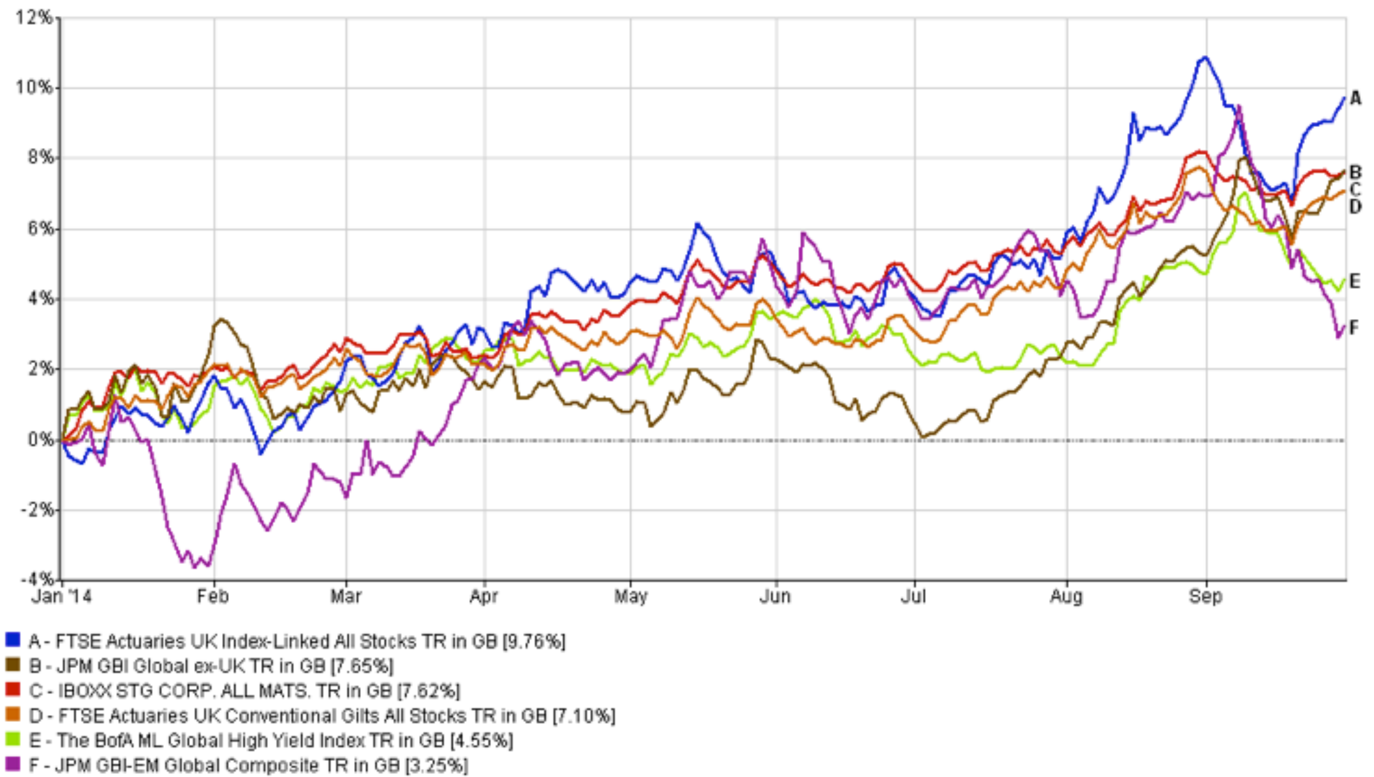
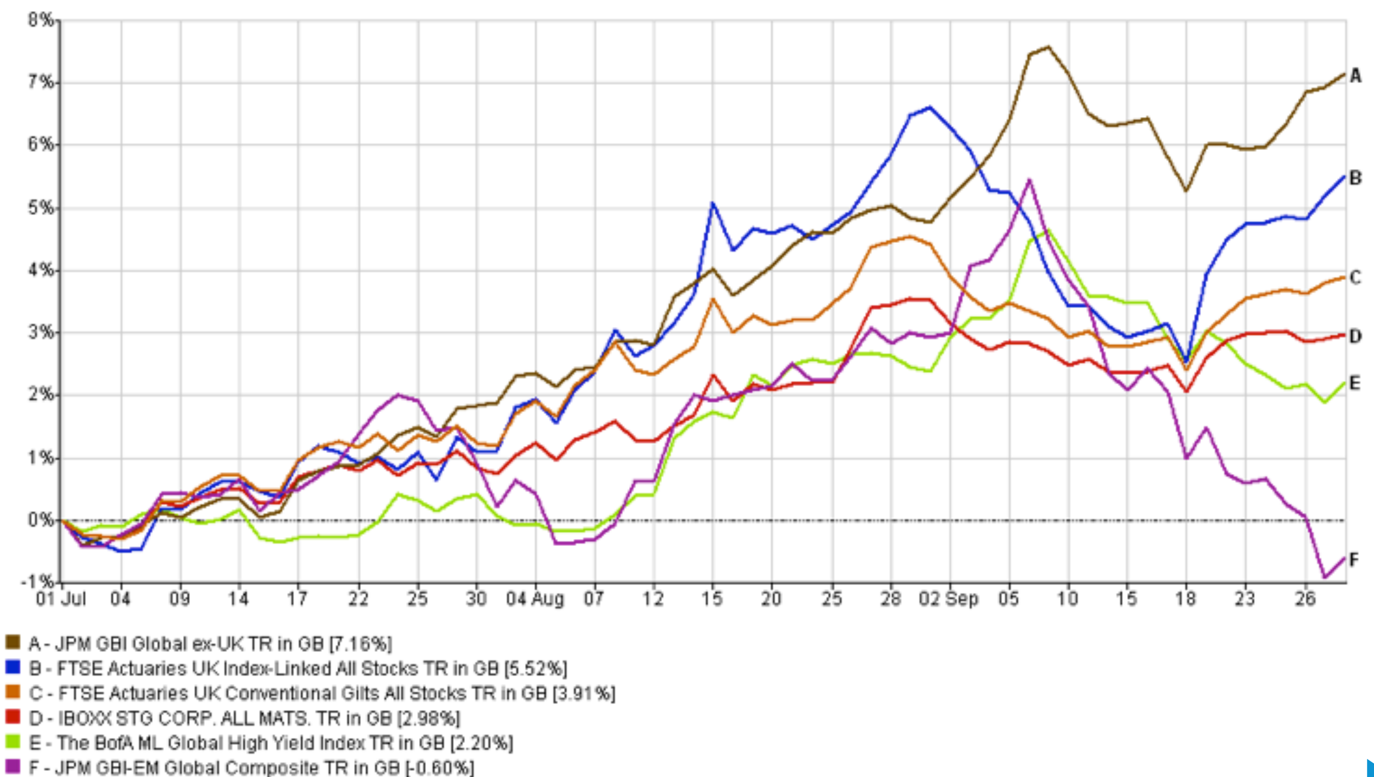


Chart showing quarter three returns for major fixed income indices:



This area has been and continues to be the most difficult to manage in terms of duration and asset allocation. The position on interest rates has been one that investors have struggled with over the last year as most had anticipated rises earlier – early 2015 now looks likely. A potential difference to the last quarters review is perhaps that the timing of the first interest rate increases in the US and UK have become ever closer, although in contrast economic weakness in Europe suggests ultra loose monetary policy will be the norm there for longer.

The impact of these tensions has been seen in currency markets where the Euro/Dollar rate in particular has adjusted. Although the Euro has declined by 8% versus the Dollar year to date, its fall on a trade weighted basis is a more modest 4%. The levels of yield in core markets, even when adjusted for inflation, look unattractive on a longer term basis. Germany has 10 year yields of under 1% which gives little leeway for an eventual economic pickup in the Eurozone region. US and UK bond markets are pricing in some level of rate rise, so the long term path of the market will depend on the level at which interest rates peak. In reality it is far too early in the interest rate cycle to call this with any certainty. Short-term, markets are likely to continue fluctuating as the reduction of US monetary stimulus, expectations for Chinese and Emerging Markets growth, and expectations for UK and US interest rate rises, or lack of, will drive investor sentiment.

Over the longer-term we also expect bond yields to rise gradually and this will lead to low levels of total return, particularly in government bond markets, but there are likely to be shorter periods where bond yields look relatively attractive and offer tactical opportunities, as was perhaps the case (with hindsight) with longer-term bond yields at the beginning of 2014. The spreads of investment grade, high yield and emerging market debt over government bonds are reflective of the superior corporate financial strength and the relative financial strength of emerging economies versus developed economies, although risks regarding the latter are becoming increasingly idiosyncratic. Investors continue to question whether or not this overall outperformance relative to government bonds is sustainable but the extra yield remains attractive in an environment where decent levels of income are relatively difficult to find.

On balance the economic upswing looks likely to remain muted, which overall provides a favourable backdrop for credit. Investment grade is less risky than high yield with the latter likely to see stock selection becoming of utmost importance. High yield is that for a reason and there has already been one recent high profile default by Phones4U. Some element of fixed interest does give investors protection against unexpected turmoil, or exogenous shocks to equity markets. Once again, strategic managers, who can combine strong macro asset allocation skills with excellent stock picking are likely to continue to give the best returns to investors, especially in a rising interest rate environment.

Property

This is an area of the market that has had strong growth over the last year thanks to broader global growth. Returns from the UK commercial property market remain very strong on a monthly basis and are expected to be so for the remainder of 2014 and into 2015. This is possibly a result of investors looking for an alternative to their fixed income allocation but may also be due to the relative strength of the UK economy. It should continue to be a good diversifying asset class during these uncertain market and economic conditions with returns driven mainly by the yield, although capital growth returns are now much stronger. There are some concerns that the highest quality assets are looking overvalued, particularly in London, but they are likely to continue being a relatively safe haven due to continued strong demand for this type of asset. There is increasing investor interest in secondary markets but individual property selection will remain important here.

Summary

Investors remain in an era of financial repression. This is an environment where real interest rates remain low by previous standards and so returns from what might be considered safe assets will be extremely low by historical standards, making safe income generation a challenge in today's environment.

Low levels of real interest rates do justify to some extent relatively high equity valuations, even in a world where profit growth will be muted. In fact, the biggest threat for a significant de-rating of equities would be a rapid pickup in growth to above trend levels, which resulted in higher than expected Central Bank monetary tightening. Equity markets have already front run the economic cycle and re-rated significantly both from the initial 2009 lows and levels available after the 2011 Euro inspired setback. The re-rating has been driven to some extent by the effects of QE and ultra-loose monetary policy which to some degree is coming to an end. The exact impact of this is impossible to forecast, but higher levels of volatility in markets over the next few months than we have seen so far this year seem almost certain. Once concerns over initial monetary tightening ease, the interest rate environment for risk assets and the economic cycle is likely to remain favourable. Investors are however likely to worry about the consequences of monetary tightening which is why we expect volatility to increase. Indebted countries will hope that higher levels of US interest rates do not significantly increase their borrowing costs, which would drag down economic activity and could endanger political support for reform. This includes not only peripheral Europe but also countries in the emerging world, both in Asia and in areas such as Brazil.

One positive for equities is that they remain more attractively valued than many other asset types. Notwithstanding this, investors should maintain some exposure to fixed interest assets, especially if they are able to select a fund which has the ability to deliver positive returns in a number of different economic scenarios. Certain strategic bond funds seem best placed to fill this need. Absolute Return funds also have a place in investor portfolios, although once again some return expectations are too high for products priced against cash rates. In the Euro zone these are close to zero and therefore not much better in the UK. Manager selection will be vital here and a carefully selected basket of these products has the potential to deliver returns of cash +3% to +4%. This remains an environment where investors would be best advised to maintain portfolios with diversification and also where some powder is kept dry for future opportunities.

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