

momentum

Viewpoint

Monthly market update

February 2014



*Global choice, wise decisions,
setting new benchmarks*



global investment management

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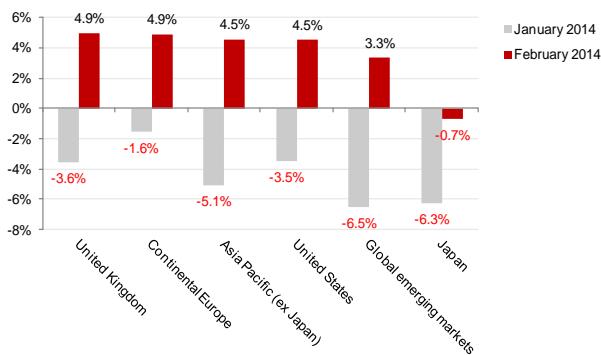
1. Market commentary

February was a month in which the majority of the news was subsumed by a rapid and substantial shift in the geopolitical environment – in this instance, the deterioration of the political situation in Ukraine, already the worst political crisis in Europe so far this century.

Until then, markets had recovered well post January's weak start to the year, with a number of major equity markets reaching multi year, and in some cases (notably the US), all time highs. A combination of mixed economic data and dovish comments from new Federal Reserve Chair Janet Yellen pushed expectations for the first rise in US interest rates further out. While the Fed intends to continue with its current plan to taper in measured steps, the central bank also intends to remain extraordinarily accommodative, focusing on broader measures than just the headline unemployment rate to gauge the health of the US labour market.

This, together with greater stability in emerging market currencies that had been hit hard in the preceding twelve months, helped markets to recover. The US, Europe and UK all saw rises of close to 5%, with only Japan failing to participate out of the major markets, down by 0.7% in yen terms. The MSCI World index added 5% over the month, while emerging markets also recovered with gains of 3.3%.

Figure 1: Equity markets recover post January's sell off (returns in local currency terms)

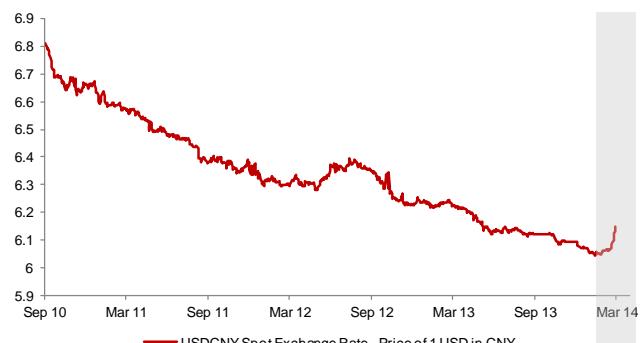


Outside the US the news appeared to support the case for a continuation of today's ultra loose monetary policy. In the euro area inflation remains very subdued, below 1% across the block, and in some

countries in negative territory. Although the European Central Bank's view is that inflation is being held back by price adjustments in peripheral states and there is no broader evidence of deflation, it is inconceivable that policy will remain anything other than exceptionally loose for a long time to come. The same applies in Japan where the Bank of Japan is taking measures to ease further in view of some disappointing growth statistics and in anticipation of the 3% sales tax hike in April. Only in the UK, where the economic recovery is steadily gaining traction, is there any prospect of a tightening of monetary policy in the next couple of years, but even there the Bank of England is using forward guidance to ensure market expectations remain well anchored.

Outside developed markets, events in China caused concerns and confusion during the month. In particular, the sudden move by the People's Bank of China (PBOC) to weaken the renminbi led to heightened investor uncertainty and confusion around the reasons for the fall. Although modest in scale – a decline of 1.4% over the month – the fall happened in a period of only a few days and represents the biggest fall in the currency since the devaluation in 1994. The one way climb of the currency since that time has encouraged huge capital inflows and speculative carry trade positions, and it might be the central bank's tactic to discourage these flows by reminding the market that the currency is susceptible to volatility. Whatever the reasons, the fall came in the wake of further disappointing data confirming the slowdown underway in China.

Figure 2: USDCNY spikes upwards during the middle of the month



The factors which drove equity markets higher – namely signs of the continued recovery in the developed world, but at levels that are unlikely to trigger an early tightening of monetary policy – also pushed bond markets higher. Yields on safe haven government bonds declined slightly over the month, while credit performed well.

A key factor in driving the prices of safe haven assets higher in the last few days of the month was the rapid deterioration of the political situation in Ukraine. The overthrow of the President and emergence of a new pro-west interim government, led to an immediate and powerful response from Russia. The military takeover of Crimea was declared necessary by Russia in order to protect the security of the region's near 60% Russian speakers. Russia points to the overthrow of a democratically elected government, a current government which lacks an inclusive and nationwide mandate, lawlessness and nationalist extremists. What it does not mention is the enormous strategic importance of Ukraine, with Russia's Black Sea fleet based in Crimea providing it with one of only two warm water, year-round ports as well as access to oceans otherwise a long way from Russia's Arctic ports. Western leaders have so far talked about pulling out of G8 meetings and other diplomatic moves, but it remains to be seen what impact this will have on Russia.

As at the time of writing, the most likely outcome appears to be a referendum. However, there is considerable uncertainty about the end result of the crisis, even if it seems to us that the risks of this becoming a drawn out political drama between Russia and the west are slim. The immediate impact on markets has been to weaken the ruble (down about 10% so far this year) while Russia's stock market has also fallen sharply, -7% in the first week of March. However there has been no widespread indiscriminate sell off and safe haven assets such as US treasuries and gold have not spiked upwards. Investors are hoping to see a peaceful and diplomatic solution to the problem, and so far appear to have placed a low probability on a major fallout.

If anything we believe that events such as this, which at the margin result in reduced business confidence and the prospect of a negative jolt to growth, will ensure that central banks will be even more cautious about tightening policy. The issue is, however, a timely reminder of the risks of investing in emerging markets. Russia for some time has appeared to be an extremely cheap market; this episode serves to remind investors why a low valuation may at times be appropriate to the level of risk.

Source: Bloomberg. Returns in US dollars unless otherwise stated. February 2014.

2. Market performance

To 28 February 2014				
Asset class/region	Index	Currency	Month	Year to date
Developed markets equities				
United States	S&P 500 NR	USD	4.5%	0.9%
United Kingdom	MSCI UK NR	GBP	4.9%	1.2%
Continental Europe	MSCI Europe ex UK NR	EUR	4.9%	3.3%
Japan	Topix TR	JPY	-0.7%	-6.9% ^e
Asia Pacific (ex Japan)	MSCI AC Asia Pacific ex Japan NR	USD	4.5%	-0.8%
Global	MSCI World NR	USD	5.0%	1.1%
Emerging markets equities				
Emerging Europe	MSCI EM Europe NR	USD	2.0%	-7.2%
Emerging Asia	MSCI EM Asia NR	USD	3.3%	-1.7%
Emerging Latin America	MSCI EM Latin America NR	USD	1.8%	-7.8%
BRICs	MSCI BRIC NR	USD	2.3%	-5.6%
Global emerging markets	MSCI EM (Emerging Markets) NR	USD	3.3%	-3.4%
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	0.3%	1.9%
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	0.5%	2.7%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	1.0%	2.9%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	2.0%	2.7%
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	0.2%	2.4%
UK Corporate (investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	GBP	0.3%	2.6%
Euro Government Bonds	Citigroup EMU GBI TR	EUR	0.7%	2.9%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	0.6%	1.9%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	EUR	4.1%	2.5%
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	0.2%	1.1%
Australian Government	JP Morgan Australia GBI TR	AUD	0.2%	1.4%
Global Government Bonds	JP Morgan Global GBI	USD	1.2%	2.9%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	1.4%	2.5%
Global Convertible Bonds	UBS Global Focus Convertible Bond	USD	4.0%	3.8%
Emerging Market Bonds	JP Morgan EMBI+ (Hard currency)	USD	3.7%	2.1%

Source: Bloomberg

To 28 February 2014				
Asset class/region	Index	Currency	Month	Year to date
Property				
US Property Securities	MSCI US REIT NR	USD	4.9%	9.3%
Australian Property Securities	S&P/ASX 200 A-REIT Index TR	AUD	3.3%	3.8%
Asia Property Securities	S&P Asia Property 40 Index NR	USD	-0.6%	-7.1%
Global Property Securities	S&P Global Property USD TR	USD	3.8%	2.9%
Currencies				
Euro		USD	2.3%	0.4%
UK Pound Sterling		USD	1.8%	1.1%
Japanese Yen		USD	0.3%	3.4%
Australian Dollar		USD	2.0%	0.1%
South African Rand		USD	3.4%	-2.3%
Commodities & Alternatives				
Commodities	RICI TR	USD	5.4%	4.1%
Agricultural Commodities	RICI Agriculture TR	USD	7.2%	6.3%
Oil	ICE Crude Oil CR	USD	0.7%	-2.4%
Gold	Gold Spot	USD	6.6%	10.0%
Hedge funds	HFRX Global Hedge Fund	USD	1.5% ^e	1.2% ^e
Interest rates				Current rate
United States	29 January 2014	USD	0.25%	-
United Kingdom	6 February 2014	GBP	0.50%	-
Eurozone	6 February 2014	EUR	0.25%	-
Japan	#VALUE!	JPY	0.10%	-
Australia	4 February 2014	AUD	2.50%	-
South Africa	29 January 2014	ZAR	5.50%	-

^e Estimate

3. Asset allocation dashboard

	 Positive	 Neutral	 Negative
Asset class	View		
Equities			
Developed equities			
UK equities (relative to developed)			
European equities (relative to developed)			
US equities (relative to developed)			
Japan equities (relative to developed)			
Emerging market equities			
Fixed Income			
Government			
Index-linked (relative to government)			
Investment grade (relative to government)			
High yield			
Loans			
Emerging market debt			
Convertible bonds			
Alternatives			
Commodities			
Property (UK)			
Currencies			
GBP			
Euro			
Yen			
Emerging market currencies			



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