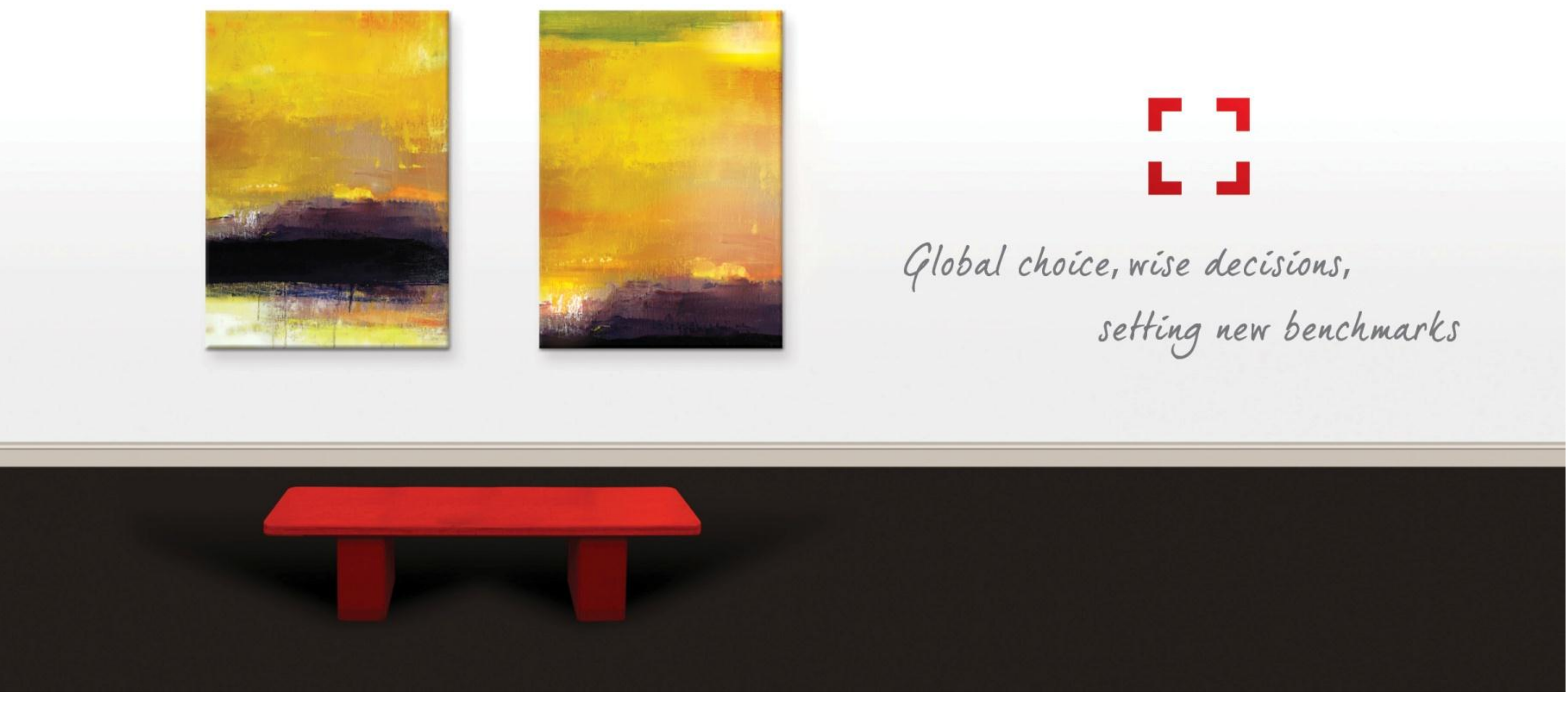
momentum

Viewpoint

Monthly market update

May 2014



global investment management

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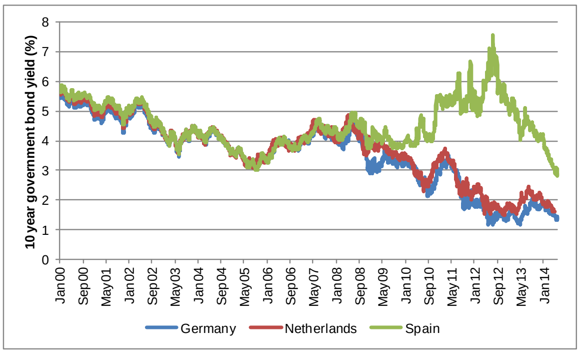
1. Market commentary

Volatility remains remarkably low across markets, with most asset classes following an upward trend in May. Equities returned 1.4% in developed markets while emerging markets added 4.5% (both in US dollar terms), to move them marginally ahead of their developed counterparts for the year. An increasingly dovish tone from central banks followed news of generally sluggish, and in some cases, disappointing economic growth. This has resulted in expectations that interest rates will stay "lower for longer" providing further support for bond markets.

Indeed, fixed income returns were arguably the most noteworthy area of the markets last month. Despite the fact that yields had already fallen from the end of 2013 they fell further in May, resulting in government bonds returning over 1% in the US, UK and the euro area, to take their year-to-date returns to around 4% in their respective local currency.

Increasing concerns about secular stagnation, the prospect of monetary loosening in Europe and close to zero short term rates for a long time ahead, all combined to push bond yields across the euro area down. German 10 year yields fell close to 1.2% from circa 2% only six months ago. Elsewhere, yields on several European government bonds including Spain and the Netherlands fell to all time lows.

Figure 1: German, Dutch and Italian 10 year government bond yields



Aside from developed market government debt, the most notable moves were in emerging market debt, which returned 2.9%, continuing the sharp recovery from last year's sell-off. With a return of 8.4%, this has been one of the best performing asset classes to date in 2014. In contrast, high yield bonds fared less well, underperforming government debt, whereas investment grade credit matched the return from government paper in May.

The most important economic activity data came from the euro area, where first quarter growth registered a disappointing 0.2%. Excluding Germany, where the economy grew by 0.8%, output fell by 0.1%, with Italy's economy shrinking and France stagnating.

The news heightened expectations that the European Central Bank (ECB) would act to ease monetary policy at its meeting at the start of June. ECB President, Mario Draghi, duly unveiled a new package of measures. As expected, the deposit rate has been moved from zero to -0.1% (i.e. banks now have to pay the ECB on excess reserves parked at the Bank), and the main refinancing rate has been lowered from 0.25% to 0.15%. Perhaps more importantly, Draghi also introduced a programme to encourage lending to businesses – Targeted Long Term Refinancing Operations (TLTROs) – worth up to EUR 400 billion.

In the US, Q1 growth was revised down to -1.0%, well below consensus expectations. However, most of the weakness has been attributed to transitory factors, notably the severe winter weather and reduced inventory accumulation. Although the data since then have been mixed, the trend appears to be for improved growth in Q2 and beyond, with leading indicators and consumer confidence all pointing upwards.

As expected, Japan produced a strong first quarter growth print of 6.7% annualised, due to discretionary spending being brought forward ahead of the 1 April sales tax increase. In the immediate aftermath there has been a sharp drop-off in spending but anecdotal evidence from Japan suggests that fears of a sustained slump in activity levels are as yet unfounded.

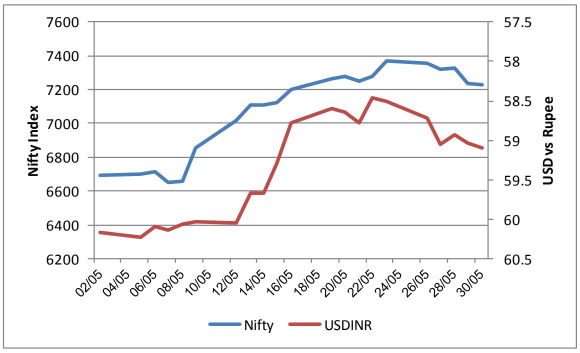
China continues to provide cause for concern. Reports of increasingly widespread falls in property prices and distressed property developers have been circulating. This is somewhat unsurprising considering the credit tightening in China and the oversupply of property in a number of areas. Subdued activity has been reflected in low inflation, with producer prices falling by 2% year-on-year and consumer prices growing by only 1.8%.

As the ECB eases monetary policy, the US Federal Reserve (Fed) also remains dovish on interest rate policy. Although tapering is expected to continue through the remainder of 2014, Fed Chair Janet Yellen has made it clear that the Central Bank is planning to keep rates low for some considerable time to come. In a speech to the Joint Economic Committee of Congress she said that “a high degree of monetary accommodation remains warranted”, “labour conditions are far from satisfactory” and “inflation below target poses risks”.

Away from central banks, another key feature of the month was politics, with important elections in Europe, India and Ukraine, together with a military coup in Thailand. Elections to the European Parliament across the EU saw a notable swing across nearly all countries to anti-establishment, anti-EU, anti-euro, anti-austerity, and anti-immigration parties. Although mainstream parties remain in the majority, there is no doubt that euro-sceptic and protest parties will influence policy making at both EU and individual country level.

In India, the BJP party led by Narendra Modi scored a resounding victory in the general election, with the biggest winning margin in 30 years and a clear mandate for pursuing reform, including a more business and market-friendly approach to policy. The Indian rupee and stock market soared by 10% in May, first on the prospect and then the reality of a change in power.

Figure 2: Performance of the Nifty Index and Indian rupee vs. US dollar.



Despite the weak economic news of late, leading indicators are pointing to improved prospects for a steady pick up in the key US economy, and in Europe through the remainder of 2014. With the Federal Reserve’s tapering and interest rate policy now well flagged and discounted in the markets, and its increasingly dovish tone about future interest rate rises (lower for longer), this bodes well for more economically sensitive asset classes, notwithstanding the challenges posed by a Chinese slowdown and/or a misstep from policymakers.

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

2. Market performance

		To 30 May 2014		
Asset class/region	Index	Currency	Month	Year to date
Developed markets equities				
United States	S&P 500 NR	USD	2.3%	4.7%
United Kingdom	MSCI UK NR	GBP	1.5%	3.2%
Continental Europe	MSCI Europe ex UK NR	EUR	2.6%	7.1%
Japan	Topix TR	JPY	3.4%	-6.8%
Asia Pacific (ex Japan)	MSCI AC Asia Pacific ex Japan NR	USD	3.2%	5.3%
Global	MSCI World NR	USD	2.0%	4.3%
Emerging markets equities				
Emerging Europe	MSCI EM Europe NR	USD	8.3%	-1.7%
Emerging Asia	MSCI EM Asia NR	USD	4.1%	4.0%
Emerging Latin America	MSCI EM Latin America NR	USD	-0.1%	2.9%
BRICs	MSCI BRIC NR	USD	4.6%	0.5%
Global emerging markets	MSCI EM (Emerging Markets) NR	USD	3.5%	3.4%
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	1.1%	3.4%
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	2.2%	6.0%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	1.4%	5.6%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	0.9%	4.6%
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	1.0%	4.1%
UK Corporate (investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	GBP	1.2%	4.9%
Euro Government Bonds	Citigroup EMU GBI TR	EUR	1.0%	5.9%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	0.9%	4.2%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	EUR	-0.9%	3.7%
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	0.3%	1.3%
Australian Government	JP Morgan Australia GBI TR	AUD	1.6%	4.0%
Global Government Bonds	JP Morgan Global GBI	USD	0.5%	4.3%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	0.5%	4.1%
Global Convertible Bonds	UBS Global Focus Convertible Bond	USD	0.8%	4.9%
Emerging Market Bonds	JP Morgan EMBI+ (Hard currency)	USD	3.1%	8.6%

Source: Bloomberg

		To 30 May 2014		
Asset class/region	Index	Currency	Month	Year to date
Property				
US Property Securities	MSCI US REIT NR	USD	2.3%	15.8%
Australian Property Securities	S&P/ASX 200 A-REIT Index TR	AUD	0.0%	8.0%
Asia Property Securities	S&P Asia Property 40 Index NR	USD	6.7%	1.2%
Global Property Securities	S&P Global Property USD TR	USD	3.3%	9.7%
Currencies				
Euro		USD	-1.7%	-0.8%
UK Pound Sterling		USD	-0.7%	1.2%
Japanese Yen		USD	0.4%	3.4%
Australian Dollar		USD	0.2%	4.4%
South African Rand		USD	-0.5%	-0.6%
Commodities & Alternatives				
Commodities	RICI TR	USD	-1.7%	4.3%
Agricultural Commodities	RICI Agriculture TR	USD	-6.4%	6.9%
Oil	ICE Crude Oil CR	USD	1.3%	-1.1%
Gold	Gold Spot	USD	-3.2%	3.7%
Hedge funds	HFRX Global Hedge Fund	USD	0.5% [e]	0.8% [e]
Interest rates			**Current rate**	**Change at meeting**
United States	30 April 2014	USD	0.25%	-
United Kingdom	8 May 2014	GBP	0.50%	-
Eurozone	8 May 2014	EUR	0.25%	-
Japan	21 May 2014	JPY	0.10%	-
Australia	6 May 2014	AUD	2.50%	-
South Africa	22 May 2014	ZAR	5.50%	-

[e] Estimate

3. Asset allocation dashboard

Positive	Neutral	Negative

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

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