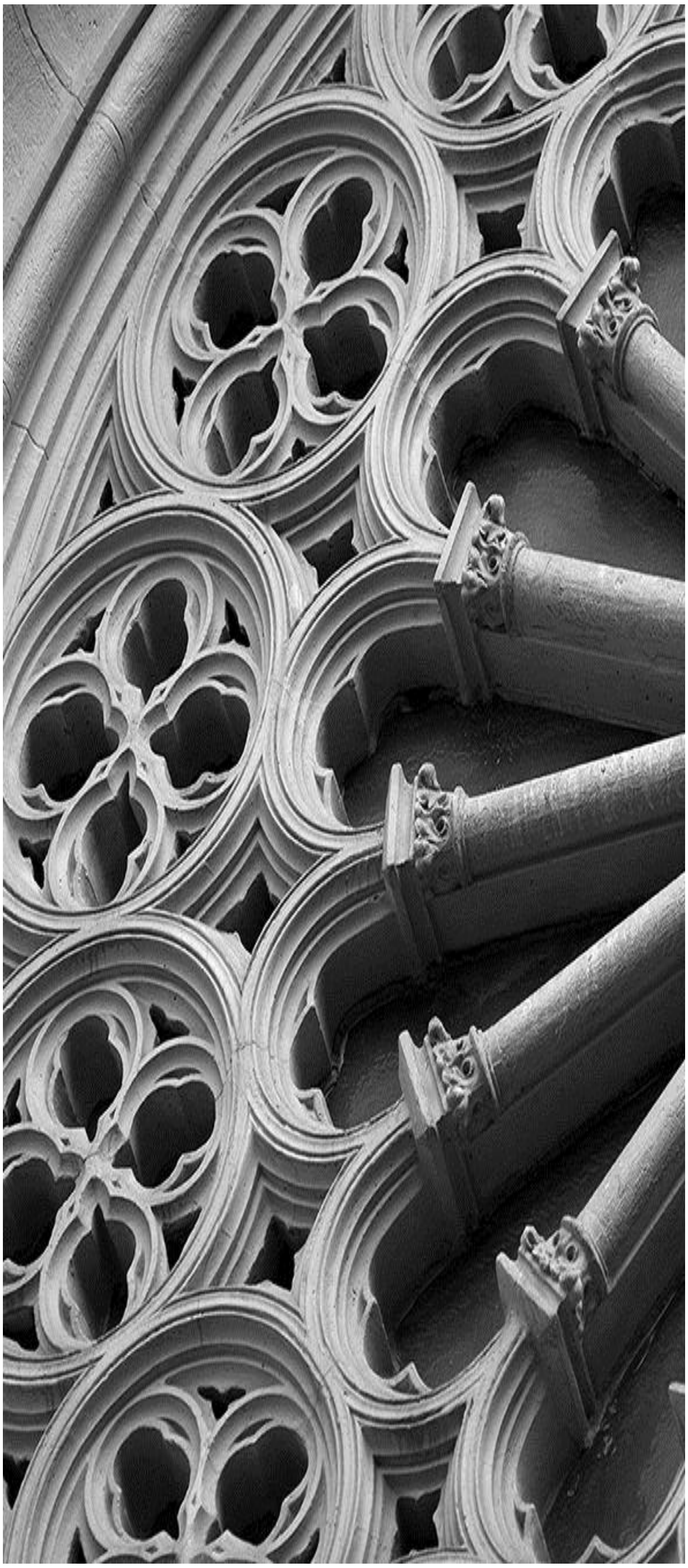
Investment Advisory Board

Meeting Summary

Third Quarter 2014

For Professional Investors Only



Highlights

- Technology could drive economic growth from here
- But a behind-the-curve US Federal Reserve hides potential danger
- Euro equities appear cheap, may find support from ECB actions
- China is in transition but the authorities know what is needed
- Bonds are expensive and security selection will be vital
- Brazilian election offers tactical opportunity

Summary

The third-quarter Investment Advisory Board (IAB) meeting revealed a diverging view on the outlook for the global economy. Technology could be a crucial driver for many stocks in the coming months, and will arguably be key to the success of entire economies, including the US and UK. However, any gains from this theme might be mitigated by a Fed that fails to keep pace with economic recovery. It is feasible that the central bank finds itself in the unenviable position of having to raise interest rates sharply, which in turn would be a shock to global equities. In fixed income and credit, selectivity remains key in an expensive market. Brazil offers an interesting tactical opportunity as the election drama unfolds.

Prospects for the global economy

The IAB noted that the role of technology is rapidly expanding in several key economies. While US productivity figures have been poor since the global financial crisis, this could be because of the way the data is collected and presented. In the US and UK – less so in continental Europe – technology could drive growth. As such, corporate performance is likely to be differentiated among those who embrace technology and those who fail to adequately do so. Germany, as a whole, remains focused on physical exports and could get left behind in the technology race. In the US, we are seeing an increase in capital expenditure and a slight increase in wages too. This could herald a short-term headwind for stocks in terms of increased costs but should pay off in the medium to long-term.

However, an opposing view was one of caution given that the US government bond yield curve could flatten and that stocks have historically tended to underperform subsequently. The reason for the potential flattening lies in the view that the Fed under Janet Yellen appears content to delay monetary tightening as much as possible and is attempting to guide the markets purely with words. Washington policymakers are apparently dissatisfied with this stance since there is a risk of a serious policy mistake if the economic data suddenly races ahead and the Fed is left scrambling to get to grips with inflation. This could dampen economic growth.

Regional stock markets

US

US equities appear to enjoy the strongest outlook, with the economy recovering faster from the credit crisis than any other region. Companies are typically cash-rich and productivity is increasing due to high levels of investment, particularly in IT and equipment, as discussed above. Improvements in consumer sentiment and the US housing market are encouraging, as is employment data. US job openings are up 20% since January 2014. Falling commodity prices should also boost US consumer confidence. Most of the IAB felt that the Fed would raise interest rates gradually around the middle of next year with any negative impact on the US economy and stock market expected to be minor.

UK

The UK has recovered relatively slowly from the crisis but economic indicators are improving. The rise of UKIP and the far right is a political risk factor for the UK. The IAB also noted that there has been a sustained rally of small and mid-cap equity indices in recent months, which may now be overbought.

Europe

In Europe, the recovery from the credit crisis has been muted and political and economic risk could worsen due to low employment growth. European corporate earnings are depressed compared with historical levels, unlike in the US, for example, where they are relatively high. France is experiencing a 'brain drain', with talent leaving the country in search of better opportunities. The IAB noted that 400,000 French people live in London, while the unpopular Hollande presidency has three more years to run. Mario Draghi, President of the European Central Bank (ECB), will have to do more to underpin growth prospects and inflation. Buying US Treasuries could help by keeping the euro competitive – see also below on this theme.

A rise in consumer confidence gives cause for hope, with an increase in eurozone retail spending recorded recently. This could yet boost domestically orientated prices and investment. Concurrently, the rate of deleveraging is slowing, particularly in peripheral Europe where there is increasing private demand. Furthermore, European equities remain cheap on many measures and much negative sentiment is already priced in. Cyclical stocks, in particular, are at a historically large discount to defensive stocks, while European dividend yields are approximately twice that of the region's bond yields. For example, some utility stocks are offering a 5% dividend, which far exceeds any return that investors can earn in the bond markets. The economic data therefore does not appear to be quite as negative as the gloomy headlines suggest, while European equities offer ongoing opportunities for investors.

Japan

The reforms that Prime Minister Abe has implemented in Japan are very impressive but further measures are necessary, in particular, tighter fiscal policy and an increase in the consumption tax in order to demonstrate fiscal rectitude. Abe's creation of the Nikkei 400 index, showcasing the country's most shareholder-friendly and best-run companies, is admirable and has highlighted the increasing importance of good corporate governance in Japan. The yen has weakened against the US dollar, which should benefit exporters and increase inflation.

Emerging

The recent strengthening of the US dollar has resulted in investors recalibrating emerging market growth prospects since dollar strength has typically been detrimental in the past. Nonetheless, there remain several attractive economies in this sphere. Mexico is expected to benefit from the liberalisation of its energy market, while developments in China and Brazil are discussed next.

China

One member of the IAB maintained his long-held belief in the ability of the Chinese authorities under President Xi to guide the economy through the current transition and this was evident in the Shanghai composite index's performance during the opening days of October. Fiscal and financial policy tools are being brought to bear and this should help to maintain a reasonable growth rate. As an economy, China's 'story' is going to be more about water, technology and the environment in contrast to the old themes of steel and iron ore consumption.

Politically, the IAB recognised the gravity of the Hong Kong protests but it was agreed that some form of face-saving deal would be struck and that there would be no repeat of Tiananmen Square.

Fixed income

Fixed income valuations look stretched across the board. The UK is expected to see two interest rate hikes before the general election in May next year, although expectations of a rate rise this November appear to have subsided. The strong performance of UK credit since the financial crisis reversed in September, with expectations of higher credit risk in the economy seemingly confirmed by several negative issuer-specific stories, in particular, Tesco, Phones4U and Balfour Beatty.

In the US, there was some value in the Treasury bond market. Longer-dated paper is expected to perform strongly in the coming months, while record short positioning in two-year Treasuries provides an opportunity to go long. In Europe, nominal bond yields are very low by historical standards and real yields are negative.

Emerging markets are offering attractive returns in such a low-yield environment. Low oil and food prices should help to reduce inflation in these markets and bolster returns. There are some strange anomalies developing between emerging market bonds and some developed market equivalents. The pricing of credit risk in Italy and Brazil provides a good example. Italy's outstanding debt stands at 138% of GDP, while Brazil's is much lower at 60%. Yet, the credit default swaps in Italy and Brazil are trading at a similar level, with Italy at 120 bps and Brazil at 140 bps. The likely reason for Italy's 'undeserved' creditworthiness is the implicit guarantee for the eurozone, spelt out by the ECB in the summer of 2012.

Given the difficulty of identifying value in the credit markets, it will be increasingly important to conduct more in-depth research of smaller companies, where there is less coverage and therefore more potential pricing inefficiency. Aligning portfolios to long-term themes including technology, as discussed, will also be vital. Fund managers should therefore not be restricted by their investment mandates and should invest with a more contextualised view, which takes into account how they believe central banks will act.

The IAB discussed the nature of a future ECB quantitative easing programme and one member raised the possibility that the central bank could buy US Treasuries in an attempt to keep the euro pinned low against the US dollar. This was felt by other IAB members to be unfeasible and surely only a final resort for Draghi. However, the benefits of a weak euro were accepted by the wider group.

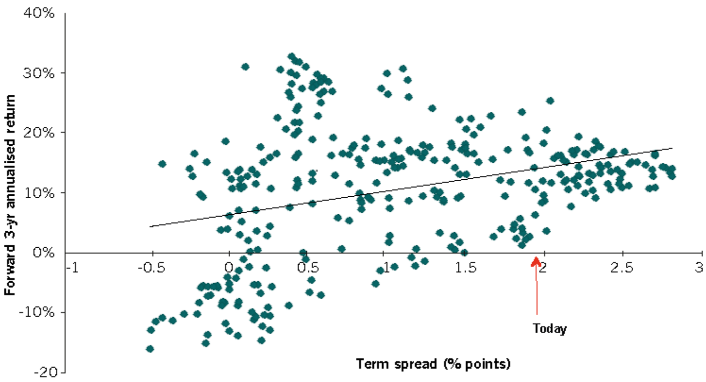
In currencies, the moves have generally not mirrored those of their respective bond markets. This is unsurprising given that the latter have been largely influenced by central bank action, whereas currencies have been much more driven by speculative flows. The weakening of the euro is welcome relief, particularly for Germany as a large net exporter.

Tactical opportunity – Brazil

Brazil's economy recently tipped into recession, following two consecutive quarters of negative growth, while inflation has hit 6.75%, the highest level in three years. The government blamed a weak global recovery from the financial crisis and several public holidays during the month-long football World Cup.

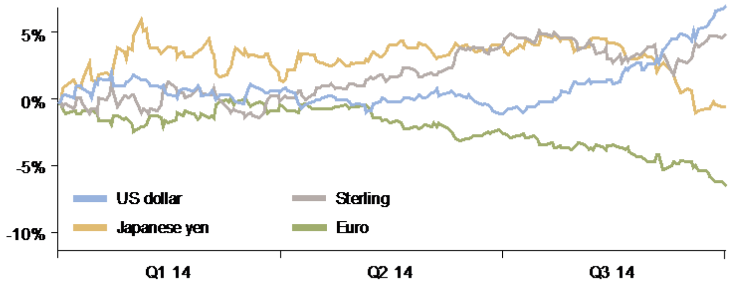
This has proved a challenge for the left-wing incumbent Dilma Rousseff in the country's general election. She has, however, emerged ahead of her rivals after the first round of polling, though she failed to secure an outright majority and will therefore face a run-off in late October with Aécio Neves of the centre-right opposition. One board member suggested that if Neves comes to power with Arminio Fraga as Finance Minister, the Brazilian economy is likely to benefit as a result of the strong reforming programme advocated by the two.

Term spread and forward 3-year annualised returns
30 years from 31 Oct 1984



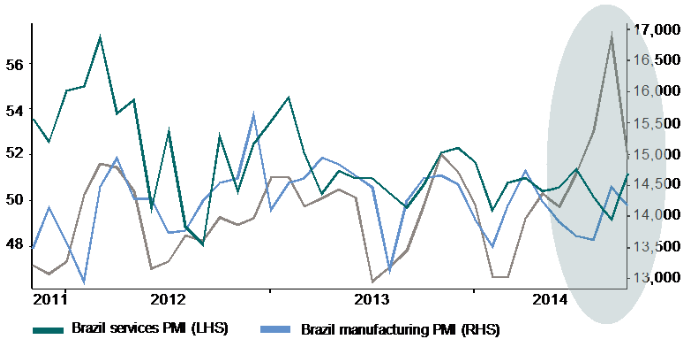
Source: GAM

Trade-weighted currency returns
31 Dec 2013 to 30 Sept 2014



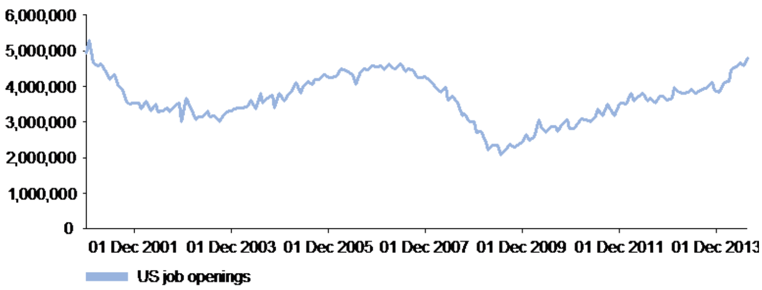
Source: GAM

Brazil – bad news gives market hope of reform
From 31 Oct 2011 to 30 Sep 2014



Source: Bloomberg, MSCI

US Job openings
1 Dec 2000 to 1 Dec 2013



Source: Bloomberg

Past performance is not indicative of future performance. Performance is provided net of fees.

The Investment Advisory Board (IAB) is a dedicated group of highly skilled, senior investment specialists with expertise across all the major asset classes as well as an in-depth understanding of macroeconomic and monetary policy. Chaired by Graham Wainer, its objective is to advise on general investment strategy, including strategic and tactical asset allocation for global equities, fixed income and credit, alternative investments and currencies. The agenda is set by the Investment Team with the objective of extracting views relevant to the management of a broad range of client portfolios.

Board Members

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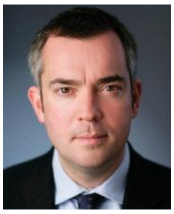

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GAM Alternative Investment Solutions

Graham Turner
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GFC Economics

The IAB meetings are also attended by the GAM Managed Portfolios Investment Team.