Investment Advisory Board Meeting Minutes Summary

4 Dec 2012

Board:	Graham Wainer (Chairman)
	James Aitken
	Graham Turner
	Tim Haywood
	Anthony Lawler
	Niall Gallagher
Attendees:	David Solo
	The Investment Team

The year-end IAB meeting came after a volatile quarter, in which the focus of investors switched rapidly from election results in the US and in Spain, to Greek bailout negotiations, then to the US fiscal cliff. Equity markets fell sharply in early November before recovering to finish the quarter to date flat or marginally higher. With this in mind, Board members were reminded that they had reached an overwhelmingly bullish conclusion in the September meeting and were asked if these views had now changed.

US

In terms of the US, the view had certainly not changed and, if anything, the case for being more optimistic had grown since the last meeting. On the political front, the debate is now about who takes on the main burden of fiscal cuts rather than whether austerity should happen and this is a major positive because the focus should be on keeping bond yields low in order to support the housing market. On the latter point, the housing sector has been enjoying a welcome recovery over the past few months, which augers well for US long term recovery prospects. At the same time, corporate profits remain strong and there are clear signs that the private sector is deleveraging. However, we should note that the rational tactic for President Obama is to take fiscal negotiations past the end-year deadline in order to secure tax increases on the wealthy. This brinkmanship is a dangerous game and puts the recovery at risk. There was also some concern regarding the likelihood and extent of entitlement cuts.

On the subject of why the previous bullish call had not been borne out by market developments so far, the slow build up in the Fed's asset purchase programme was offered as the main culprit. Nonetheless, the central bank's balance sheet has begun to grow now and this should have a positive effect on risky asset prices over the coming months. More specifically, the spread between consumer mortgage rates and the yield on tradable mortgage backed securities is a key statistic for Fed members and this gap has started to narrow recently, which is good news. The main worry for one member of the Board was the very low and falling rate of growth in average hourly earnings, which feeds into low credit demand and low consumption. This member wanted to see positive developments in these numbers before making an unequivocal bullish call.

Europe

The outlook for Europe is more difficult, primarily due to the shape of political discourse. While Greece is an obvious problem, separatist movements in Spain indicate a groundswell of opinion that wants to move away from the core rather than towards closer integration. Germany's Chancellor Merkel recently suffered a reduced majority in the Bundesrat, which has triggered a less hard-line approach towards Greece. Essentially, the Greek bailout process will continue with few hitches. The bigger problem is that the only way for Greece to remain in the Eurozone over the long term is for the IMF and the rest of the Troika to take a hit, which implies that delaying tactics will be employed.

However, there are positive dynamics in play in Europe that are not reported very often. For example, current account convergence between EU countries is progressing much quicker than the European Commission predicted. Furthermore, the region's exports to non-EU countries have held up well and have outperformed those of the UK. This supports the case made by advocates of structural adjustments as opposed to "quick fix" currency depreciation. But the structural adjustment path does not create many jobs and the strength of the global economy remains crucial in the euro crisis next year. In the meantime, the ECB could and should ease monetary policy further to counter the weakening trend in the economy and regional governments should be wary of allowing lower bond yields to slow the essential process of reform.

Putting the macro considerations aside, the performance of peripheral Eurozone bonds and selected equities shows that the region still offers good investment opportunities. ECB President, Mario Draghi, has effectively eliminated financial tail risk with his Outright Monetary Transactions policy, which has been crucial in bringing sovereign bond yields down. On the other hand, the European equity market is cheap compared with the US. Based on a cyclically adjusted Shiller Price/Earnings ratio, the gap between the European and US markets has grown as the crisis has deepened. This is despite similar earnings growth. One member made the important point that investors should be highly selective in the European equities arena.

Emerging Markets and Japan

Discussion then turned to the outlook for the emerging markets, with particular reference to China. The changing Chinese economic landscape with a greater orientation towards the consumer will be crucial for developments in many developing nations, as well as for Japan. In terms of the latter, its economy has been propped up by large scale capital goods exports to China but, now that the Chinese authorities are attempting to move industrial activity higher up the value chain, these exports will not be required quite as much. This may partly explain why there is now a concerted effort to weaken the yen through calls for much more aggressive monetary policy. One way in which this could be achieved, according to Japanese policymakers, is to introduce a 2% inflation target. The major criticism from the Board was that a focus on ending deflation is incorrect, especially when unemployment is so low by international standards. The Japanese bond market is at far greater risk from persistent current account deficits and reckless fiscal policies than from mildly falling prices. Another important point is that viewing the depreciating yen through the prism of the US dollar is misleading because the Japanese are more focused on local competitors, such as South Korea and China itself, and we know that the latter two are much better at currency manipulation than Japan. If an open currency war commences, the outcome is indeterminate.

China's new policies should, however, have a more discernible positive impact on smaller emerging market economies in South East Asia and Latin America who can seize the opportunity to fill the gap at the lower end of the value chain. This view is dependent on a strengthening US economy and a stabilising China with lower inflation but the Board was generally confident that selected developing economies will perform well over the coming year and beyond.

Currencies

Finally, Board members were asked for the views on the major currencies.

There was widespread agreement that sterling was the currency most at risk from weakness over the coming year. The current account is in deficit due to the weakness of the economy, while the budget deficit has not been dented in the past few years of austerity. Also, the political situation is bad and worsening, as politicians debate the merits of cuts.

One member of the Board was more optimistic that the incoming governor of the Bank of England, Mark Carney, would be more aggressive than his record at the Bank of Canada would suggest. He is likely to be deeply involved in the Financial Policy Committee as well.

The euro, on the other hand, is likely to remain resilient due to trade surpluses but, of course, a weaker currency would actually be beneficial, given that the euro area's trade surplus is 95% comprised of Germany's trade surplus and other countries are struggling much more. That's why there won't be too many cheers in support of the strength of the euro.

Finally, there was mildly bullish sentiment regarding the US dollar, based on an improving economy, lower levels of leverage and likely positive steps on the road to government deficit reduction. The conviction level on this call was not high, however, as the politics can change quickly.

In summary, the IAB re-iterated its positive view on risk assets but tempered it with a little more caution than in the September meeting. There was a more optimistic view on the US from one member while others were slightly more reticent. Similarly, in Europe, the debt markets could perform well but the equity markets are more concerning, with selectivity necessary. The prospects for emerging markets are quite positive. Nonetheless, the most important factor remained the power of monetary policy in the US and Europe to support asset prices.