Investment Advisory Board Meeting Minutes Summary

12 June 2013

Attendees: Graham Wainer (Chairman)
James Aitken
Graham Turner
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The Investment Team

Apologies: Tim Haywood
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Summary

The IAB presented a more tempered view of the global economy and markets compared with the previous meeting, but continued to emphasise the recovery in the US. Meanwhile, there was general agreement that, while the risks remain significant, Europe is at an early stage of recovery and could be where the opportunities lie for investors. In the UK, small and mid-cap stocks were deemed to be the wisest choice. As for the Emerging Markets, weakness was seen likely to continue and a short position on the Australian dollar was recommended as the best way to benefit. There was disagreement on the short term prospects for Japan and it was unclear whether the current policy would work, both for the economy and for asset markets.

The second quarter IAB meeting was held amidst a generalised rise in bond yields and significant reversals in some equity markets, most notably in Japan. Given the bullish run of the past year and the evidently improving economic outlook for the US in particular, the key question now was whether a significant and sustained change in market sentiment had begun. Against this backdrop, the IAB members were asked for their macro and strategy views.

The markets

Over the past 4 years, there have been a number of 50 basis point rises in long duration US Treasury yields but the latest move is the first to have triggered widespread volatility across virtually all risk assets, not least in Emerging Markets. The reason that this time has been different is that implied volatility had never previously been this low. In this sense, recent events are precisely what the US Federal Reserve wants to occur – the aim is to remind investors that volatility cannot remain low indefinitely and that many are taking on too much duration risk at the wrong price, given that monetary policy will be normalised at some point sooner or later. The Fed and some other central banks want to check the clamour for yield that has been widespread in markets in the past few years.

Meanwhile, the US debt market has so far behaved well with an orderly rise in yields. Convexity risk – the risk that different parts of the yield curve have different sensitivities to interest rate rises – has been largely absent because the Fed is such a large holder of agency mortgage backed securities and other fixed income assets. However, last year's peak yield of 2.42 on the 10 year Treasury now seems increasingly likely and, if this threshold is broken, the equity market sell-off could take on more meaningful proportions.

In a wider context, recent events should be seen as a market shake-up. Economic growth may dip in the US over the summer as the fiscal cuts bite hardest, but activity levels should be stronger by the end of the year.

The US

The US dataflow has continued to be strong and employment data is improving. The share of long-term unemployment, while still historically high, has been falling steadily while a good leading indicator – the measure of those who are jobless, have just lost their jobs or have recently completed temporary contracts – is strongly pointing towards further improvements in the near future. Meanwhile, the median price of existing home sales recently spiked to the highest level since 1980. There is reason to believe that this will feed into increased employment in the construction sector. Indeed, job openings in the sector are up 40% year-on-year, admittedly from a low base.

One thing that would stop the recovery in its tracks from here would be an excessive rise in bond yields. On a positive note, the rapid decline in the budget deficit means that at some point, the Federal Reserve will be able to fully fund it and bond yield controllability will be greatly improved. Nevertheless, it is important for the central bank to send a clear message to the markets that low bond yields and low volatility cannot be the norm indefinitely, while making sure that recent yield rises are moderate.

Europe

There is a clear recovery occurring in the economic fundamentals in several peripheral countries. In particular, there has been a marked improvement in current account balances, not just in the weaker nations, but also in the "core" nations. Within the detail, there has seemingly been a structural shift towards exports to Emerging Market countries around the world. The balance of trade for the services sector is also displaying a rising trend.

Europe also looks attractive from a valuation standpoint. According to the Shiller PE, European equities are trading at a significant discount to historical averages while US equities are trading at a premium. These cheap valuations have been driven by earnings growth while prices have been weighed down by the uncertainty surrounding the future of the euro area. The standout sectors in terms of value are industrial cyclicals, autos, telecommunications and certain banks. The market remains cheap on the Shiller PE even if the banking sector is stripped out of the calculations, albeit a little less so.

Overall, there is no doubt that Europe continues to struggle, both in the periphery and the core, and there are significant political risks associated with very weak employment numbers. However, the turnaround of the competitiveness figures has been so profound that Europe is where the IAB believed the most attractive investment opportunities lay.

Japan

The topic of Japan's future prospects was the most controversial of the meeting. While one set of views identified the recent decline in equity prices as no more than a pull back for a market that was at its most overbought since the 1950s, another viewpoint highlighted that there has been no historical precedent for a quantitative easing programme this big whilst coupled with a fiscal deficit and debt burden of such large proportions. According to this latter view, the current set of policies would ultimately fail.

In the asset markets, valuations are still good, earnings momentum is strong and the froth in the market has been eliminated, according to some on the IAB, while the ultimate outcome of recent market troubles will surely be that the Bank of Japan will have to expand its Qualitative and Quantitative Easing (QQE) programme. On the opposing view, if the US 10 year Treasury yield goes above last year's high of 2.42, there will be virtually no incentive to hold JGBs yielding 1% and the Nikkei would fall in such a scenario.

China and the Emerging Markets

Emerging markets have generally been introducing structural reforms and this has been the narrative amongst investors. The reality, however, is that much of the performance has been China-led. The first proper test of the Emerging Markets has triggered downturns in many countries, revealing the lack of reform. For market participants, elevated volatility makes it difficult to manage the risk of trend-following and tactical trading strategies.

As for China, their slowdown has occurred as the government has focussed less on economic growth and more on orienting the economy towards domestic demand, as well as on financial sector stability. The consequences for the world economy as a whole are benign in the short term and a positive longer term, not least because a higher cost China should present less of an inflation threat to the G7. However, for countries with an export relationship with China, such as other Emerging Market nations and Australia, the impact could be more serious. Also commodity prices are likely to stay contained with the risk to the downside.

Tactical Trading Ideas

As interest rates rise, liquidity is becoming less available and more premium. This is why there should be a strong preference for simple, elegant trades.

The IAB believed that a short position on the Australian dollar is the best way to benefit from Emerging Market and Chinese economic weakness, while owning US interest rate payer swaptions or similar hedges are good ways to benefit from likely rises in US Treasury yields.

Meanwhile, one should be wary of the market for ETFs as falling liquidity is likely to trigger volatility. This is because recent regulatory changes have forced many banks to lower their holdings of high risk credit assets in order to strengthen their balance sheets and the burgeoning ETF market has taken on large chunks of this inventory. Should there be a large scale selling of ETFs, perhaps in response to falling markets, there is likely to be limited liquidity for the managers of ETFs to recall loaned-out assets and to sell them at acceptable prices.

Finally, the UK economy is beginning to recover as predicted in a previous IAB meeting but, in order to take advantage, the exposure should be oriented towards the domestic economy. This means that there should be a focus on small to mid-cap stocks rather than the large cap, internationally exposed FTSE 100.