Investment Advisory Board Meeting Minutes Summary

30 June 2014

Attendees: Graham Wainer (Chairman)
James Aitken
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MP Investment Team

Summary

The backdrop to the second quarter's Investment Advisory Board (IAB) meeting was one of positive equity markets so far this year and lower yields in developed bond markets. This environment – particularly the lower yields – went against consensus expectations, taking many investors by surprise. Markets also had to adjust to lower-than-expected GDP growth in the US this year and the relatively strong rebound in European economic activity, especially in the periphery.

The discussion initially revolved around 'terminal rates', ie when the central bank will stop hiking in various developed markets, with the conclusion that they would remain at much lower levels compared to previous cycles. There was some surprise that contrarian opportunities were not being pursued by more market participants, given that most investors were following the consensus view at present.

Potential investment considerations are summarised at the end.

USA

The US Federal Reserve's (Fed) interest rate policy was at the forefront of the discussion, with one IAB member highlighting the recent very strong economic indicators out of the US, and how these numbers should bring rate-hike expectations forward. Other members broadly concurred, but noted the Fed's difficulties in communicating a potential shift in its policy. With the central bank having articulated its particular focus on long-term unemployment, it appears unable to react in a timely manner to improving leading indicators within its current framework. So by the time the Fed does react, it could find itself behind the curve.

In the meantime the benign economic climate could foster a virtuous cycle, since companies are likely to ignore unwarranted scaremongering and start investing their sizeable cash reserves. The IT sector was cited as currently driving investment spending, job creation and real wage growth, with the latter also supporting house prices. This upbeat view was not universally shared among the board, with one member pointing out that very poor first-quarter growth, which had been revised further downwards, could persist into the second quarter too. Regarding the US equity market, there was a consensus that valuations are expensive, but equally no plausible catalyst could be seen on the horizon that might derail progress. One particular indicator of market value – the ratio of market value relative to GDP – was noted to be at its highest level since just after the Second World War. But there was no clear agreement among members as to whether this was a valuable signal for investors, since at no point in history had interest rates been as low as they are currently.

Europe

European economic growth has positively surprised this year. The news from the eurozone periphery is particularly encouraging, with Spain seeing the highest level of consumer confidence since 2001. Greece saw a decrease in unemployment and a significant rise in economic sentiment. However, one member cautioned that potential fault lines still existed that could open up at any time. Scope for economic reform in France was discussed, but members did not see a clear trigger for it, other than increasing pressure if other countries saw material improvements in their prospects.

One IAB member pointed out that European equities were still cheaply priced compared to their US counterparts. In particular, the positive economic growth scenario is yet to be factored in, which is reflected in the low prices of stocks that are geared to recovery following the sector rotation in April and May. These include UK homebuilders and media companies exposed to the periphery, while the hunt for yield has pushed defensives like telecoms and utilities into unloved territory. Meanwhile, European sovereign debt was highlighted as being very expensive.

UK

Given the UK's strong economic growth, the Bank of England's monetary policy has come into focus, in particular, the timing of the first interest rate rise. With the concept of forward guidance now abolished, the bank has returned to data-dependent decision making. Sterling has appreciated strongly year-to-date in response to the data, with one IAB member expecting as many as two rate rises before the General Election next year. Technology was mentioned as a major driver of new employment growth and one reason to go long UK equities. Within UK equities, stock selection was also highlighted as being vital.

Sharp house price appreciation was, however, seen as a concern over the longer term. The need for stronger government efforts to address house building, potentially including social housing initiatives, was discussed. General concerns were also raised about the quality of data used to measure UK GDP. Sterling's prospects versus the US dollar over the medium term were discussed. Some members felt it could appreciate further yet.

Japan

Many Japanese blue-chip companies announced share buybacks and increased dividend pay-outs over the second quarter. This trend was seen as likely to continue and accelerate as companies have hoarded cash, while earnings are stable. Contrary to Japan, corporate earnings estimates are being revised downwards elsewhere in the world. This means that equity market rallies elsewhere have led to multiple expansions, whereas in Japan the majority of the stock market's gains have been driven by earnings growth, and hence remains relatively cheap. It was noted that the yen would not need to fall further, given that the Japanese manufacturing industry appears strong enough to thrive with the exchange rate at current levels. It seems that investors are starting to realise this, with the correlation between the yen and the Topix breaking down. The index has been able to advance recently without the help of a weaker yen.

Emerging markets

The discussion on emerging markets focused on China. One board member highlighted that core inflation was below the government's target, while Chinese companies are gaining market share from Japanese competitors due to improved competitiveness. Another member noted that markets seemed surprised by the Chinese economy's resilience, having not expected the country to muddle through as successfully as it has done. The People's Bank of China was lauded for taking the right steps in managing the soft landing of the economy.

The IAB concurred that emerging markets cannot be treated simply as one asset class, with differentiation being the key to investing successfully. As such, long Chinese equities were seen as a promising trade, while short positions in vulnerable markets, such as Brazil, were also considered. In emerging market fixed income, local currency bonds offer value, but should be considered on a selective basis.

Summary of potential investment considerations

- UK housebuilding stocks
- Peripheral Europe-exposed media stocks
- Short selective European sovereign debt
- UK equities, sterling vs. majors
- Japanese equities
- Chinese equities short and medium term
- Short selected emerging market equities
- Selected EM local-denominated debt

Source: GAM unless otherwise stated.