

Investment Advisory Board Meeting Minutes Summary

21 Mar 2013

Board: Graham Wainer (Chairman)
James Aitken
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Attendees: David Solo
The Investment Team

Summary

The IAB's view was overwhelmingly bullish on US equities, based on a healthy recovery in the housing market and a resolutely accommodative central bank. The outlook for Europe was far less sanguine with concerns about the fallout from the Cypriot bailout and weak economic fundamentals in other nations. The biggest change in view was on the UK, where the IAB has become more bullish. On a tactical basis, risk should be allocated to US and UK equities, away from government bonds and bank debt and towards hedging a possible rise in US interest rates. In terms of currencies, the US dollar, sterling and the Mexican Peso were the most favoured.

The first IAB meeting of 2013 came at a time when most equity markets had enjoyed a long period of strength, primarily buoyed by the ongoing recovery in the US but also because a sense of calm had returned to Europe. Very recently, however, the momentum seemed to have eased and questions were being asked about the bailout of Cyprus. With the background set, the IAB members were asked for their macro and strategy views.

The US

The US economic recovery has continued apace and the positive assessment of the IAB has been proven largely correct so far. The housing market is leading the way and several indicators are implying that a virtuous circle is establishing itself. The rise in prices is improving consumer confidence, helping the rest of the economy, which is leading to further improvements in the market. At the same time, higher home values are persuading banks to delay some foreclosures in order to minimise losses.

The key component to these developments is the unwaveringly supportive stance of the Federal Reserve. The unemployment rate is still too high and inflation is too low so there is little risk of tighter monetary policy any time soon. But this happy status quo will become more tenuous once

the unemployment rate begins to approach the Fed's target of 6.5%, which could be as early as the fourth quarter. The Fed is unlikely to be moved but the market may well react with higher long term interest rates. New derivatives regulations could make it difficult to mitigate the impact of such a move when the time comes so it could be worth placing a hedging position now.

Before then, however, the potential for another surge in the S&P500 is significant, as long as the uncertainty in Europe can be eased.

Europe

The first attempt at a Cypriot bailout package sent the dangerous signal that deposit insurance is meaningless and that any eventual solution will require capital controls to prevent everyone pulling their money out. A muddle through is expected by the market and may well come to pass but the Greek and Spanish deficit numbers are poor and it is easy to think that the Germans are being overly strict with the Cypriots because they know they will have to face bigger bailouts in the lead up to their elections. However, while it's a good thing that the whole capital structure of a failing financial institution is being brought into play in order to protect taxpayers, including the insured depositors in the bailout process forces people to look at the deposit protection schemes in other countries and to question how many of them are fully funded. The answer is none of them.

The hope is that improving US conditions and low interest rates will prompt investors to seek higher returns in riskier areas like Southern Europe. In the short term, this is a very optimistic scenario. Europe is hamstrung by policy failures, low growth, a completely broken credit multiplier, undercapitalised banks and a central bank that, amazingly, sees green shoots of recovery at a time when economic growth is slowing throughout the region.

The UK

The biggest change in view was for the UK. While the outlook looks poor and the IAB had concurred up to this point, a deeper review of the data painted a very different picture. For a start, service sector employment is strong and the workforce increasingly comprises full-time positions rather than part time. This does not tally at all with the headline GDP figures, which are very weak, hinting that the latter could be misleading and that there is underlying strength in the economy. The UK's exposure to mainland Europe is the major reason why exports have underperformed so far, despite the sharp depreciation in the currency in recent years, but there are signs that the government is trying to diversify UK export markets.

For its part, the Bank of England is attempting to bring sterling down further. We should keep in mind that, if the incoming Governor Mark Carney is successful in reflation the economy, sterling should appreciate and the stock market should rally – indeed, equities jumped when Mark Carney's appointment was announced. Nonetheless, expectations are too high and virtually everything he may do in his first six months in charge is discounted by the markets. As a result, there is little news on the horizon that could bring the currency down.

Japan and the Emerging Markets

In Japan, markets have reacted to the aggressive stance of the new government and the newly installed central bank Governor, Haruhiko Kuroda. The central bank has pledged to buy around \$144bn (¥13trn) in assets as part of its programme to achieve a 2% inflation target, which is about \$60bn per month more than the Fed is doing, so it's a real statement of intent. Nonetheless, the inflation target is very ambitious and expectations of the impact of Kuroda are too high. The market is cheap on some valuation metrics and this could persuade investors into equities but the ultimate aim will surely involve a change in attitude by Japanese domestic investors. Stubbornly invested in fixed income, these investors may begin to switch some of their money into higher yielding equities should positive inflation be achieved on a consistent basis.

On the other hand, a yen devaluation is not a wise goal on its own because, without nominal wage increases, people's purchasing power is adversely affected. Japan really needs to engineer positive economic growth with low or no inflation.

In Emerging Markets, China narrowly avoided a crisis late last year, as it became apparent that the economy hadn't slowed down quite as much as some had feared. Looking ahead, the pace of credit growth and the inflation threat should be watched closely. It is likely that the Chinese authorities will be draining liquidity for the rest of this year.

Tactical trade ideas

With the macro view established, the IAB provided its short term tactical recommendations.

If the tactical risk budget can be split into ten equal units, up to three units should be allocated to UK equities, up to four units to US equities, one or two on Japanese equities independent of the yen, and up to two units to hedge the risk of potential US interest rate increases.

Along with a positive view on UK equities in general, UK housing stocks could also outperform. Government bonds should be avoided while the interest rate hedge should be placed now because it will be almost impossible to do so when the panic begins. This could be done through payer swaptions, forward starting interest rates or put spreads on long term Eurodollar contracts.

Meanwhile, Mexico is still a very positive story and can actually be considered a leveraged play on the US recovery. Parts of the former Soviet Union and frontier markets in Africa and Developing Asia are also worth consideration. In Asia, China is rapidly becoming an expensive trading partner, which is opening the door to lower cost exporters in the region such as Vietnam, Bangladesh and so on.

Commodities were mentioned and they have underperformed because supply is coming on stream as a result of the large capex investments in new sources, despite the better economic trend. Many of the price moves in the commodity arena have been unpredictable in recent times and managers have been caught out too often. Overall, equities were deemed to be a much better place to invest.

On currencies, long US dollar and long Mexican Peso were prime recommendations. Meanwhile, a position that benefits from the volatility of the Japanese yen could add value. The Japanese yen is likely to continue depreciating over the long term but a pullback is entirely possible at some point in the next three months.

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