Investment Advisory Board Meeting Minutes Summary

27 September 2013

Attendees: Graham Wainer (Chairman)
James Aitken
Graham Turner
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Jack Flaherty
Sandro Cerulli
The Investment Team

Summary

The IAB formed a consensual view at the September meeting. Equities emerged as the standout prospect, with all members agreed on the potential of the asset class. As discussed in the previous meeting, the US recovery remained a contributing factor driving improved equity market performance, particularly as the unemployment number approaches the psychologically significant 7% level. In Europe, political instability remains a concern, but the longer-term prospects of the region are looking more positive, with the recovery in the Spanish housing market helping to counterbalance the concerns raised regarding Greek politics. Many currencies remain under pressure as a result of tapering worries, but members were positive on the prospects of sterling in particular. Unsurprisingly, fixed income was unloved, with the board agreeing that investors are currently hungry for genuine growth stories, although short fixed income positions could prove useful portfolio hedges.

The third-quarter meeting was set against a backdrop of improving economic data. Despite the recent threat of rising US interest rates and military action in Syria, the broad spectrum of numbers forecast a positive trajectory for the economy and markets. With the US, the UK and Europe all displaying signs of promise, the IAB was asked how much further equity markets could go, and what risks would likely threaten the current trajectory.

USA

The Federal Reserve's (Fed) accommodative monetary policy has undoubtedly driven both US and global asset prices this year. Many investors are hanging on every word emanating from the central bank in a bid to second-guess the future direction of monetary policy. The start date of tapering action is itself hotly debated and this caused both equity and fixed income markets to sell-off earlier in the quarter.

In particular, the Fed's decision to use unemployment rates as one of the preconditions for tapering proved controversial. As unemployment fell to 7.3% the Fed was implicitly pushed towards its trigger point before it was ready to act. One member of the IAB commented that since unemployment levels were coming down for the 'wrong' reasons, the Fed could suspend any action until it is truly ready to increase rates. Thus, tapering has now become a moving target for investors to interpret.

The hype around tapering reflects the growing trend of 'policy fixation' that is impacting the US markets. Fed officials are slowly trying to wean observers off the idea that they will provide all the support markets require and instead stress that they will no longer be acting as the marginal buyer of last resort. The IAB agreed that investors would be wise to concentrate on US fundamentals, which are looking reasonable on the whole, but still have hedges in place to account for inevitable market bumps along the way. On the US government shutdown, the overall consensus was that it would 'all get sorted out in the end' since no political party will wish to be associated with the worst-case scenario of outright default.

Europe

While the eurozone continues on its steady recovery trajectory, a primary risk for markets is policy execution, particularly in 2014, and the return of headline risk. While it is unlikely that we would have to endure another period of turmoil as suffered between 2011 and Mario Draghi's 'Whatever it takes' speech in July 2012, the eurozone is still not completely out of the woods yet. Nervousness surrounding changes to the German constitution should be viewed largely as market noise but the real uncertainties come from Greece. The country's banking sector is facing pressure to keep balance sheets clean, but given that the finance minister appears to have ample funding held in the Financial Stability Fund, the bigger names should enjoy a relatively stable outlook.

Turning to Spain, the current account deficit has improved, aided by rising consumer export and capital goods numbers. Investment in the auto industry is also contributing to the recovery. The property market is improving, although prices are not necessarily cheap in relative terms, being at many multiples of local salaries. But overall, Spain demonstrates that despite the straitjacket of the single currency, successful adjustment can be undertaken. One IAB member emphasised that we must be encouraged by how far the recovery has progressed to date. Overall, European equity valuations are attractive and opportunities do exist.

UK

While media headlines continue to dwell on economic negatives, several UK sectors are quietly gaining significant growth momentum outside of the media spotlight, with technology being a notable example. London in particular is seeing a boom in this area, with many start-ups and small businesses defying the wider story of low growth and economic uncertainty.

One key driver behind this is the fact that consumers have modified their spending behaviour and now favour digital purchases, such as smartphone apps, over more traditional goods, such as cars. This is both for their user appeal and cheaper pricing points. Indeed, the number of patents registered over the past 12 months has doubled on the previous year, with the boom in development helping to fuel job creation in the innovation arena.

The rise of UK tech indicates that consumers have not been hit as hard as we have perhaps been led to believe, and the sector itself has become an interesting investment area.

Emerging markets

Despite having a tough summer when the sell-off in US Treasuries caused a regional market fall and put pressure on local currencies, the emerging markets' share of global trade continues to rise and so the theme still presents potential.

However, investors would be wise to consider their liquidity requirements when evaluating this area, particularly local credit and fixed income markets, as the recent wash of 'hot money' may make an exit harder than anticipated. The largest liquidity providers in the emerging interest rate markets are the global banking giants, which are coming under increased pressure to shrink their balance sheets, pass on the cost of their credit and rates businesses and begin exiting these unprofitable sectors. Multinational corporates with their bases in developed countries provide a more appealing way of accessing emerging markets without compromising on liquidity.

Investment ideas

Currency markets currently offer some interesting trading opportunities, despite elevated volatility levels over the summer months. Regarding sterling, there is a misconception that Bank of England Governor Mark Carney wants to weaken the currency. The board shared the view that at GBP 1.60 against the US dollar, sterling was still good value and there was room for further appreciation.

In Australia, the mining boom is coming to an end, impacting GDP numbers, yet property prices are still rising. Whether residential construction rates can continue unabated and thus plug the hole left by mining remains to be seen. The board believed that shorting the Australian dollar ahead of what could be a multi-year wind-down would be profitable.

In the equity markets, the board was positive on long risk positions, which could capture the general improvement in economic conditions. The US was the favoured market, and with macro data grinding upwards the board anticipated a triggering of pent-up capital expenditure by corporates. Beneficiaries of this would typically be the classic infrastructure industrial names, as well as information technology. Tactical hedges designed to counter inevitable bumps in the market's upward trajectory were also advised.

Source: GAM unless otherwise stated. (Unless otherwise noted, where shown, performance is shown net of fees, on a NAV to NAV basis).