Parallel
Investment Management

Market Commentary November 2013

Over recent months the prospect of FED tapering has been at the forefront of investors' minds, with the belief that the FED would announce a reduction to their $85 billion a month bond buying programme. The decision to delay tapering, amid concerns the US economic recovery is slowing, surprised the market and triggered a strong rally in equity and bond sectors. Any reduction in tapering will be reflective of stronger economic data, which will in the long run be positive for markets. Concerns regarding a slowdown in China have somewhat faded and stronger data from the developed world should assist Asian and Emerging Markets, as consumption and demand for exports increase. As a result we are positioning our portfolios to take advantage of the improving outlook for equities worldwide.

UK

The outlook for the UK economy continues to improve across the board, with stronger consumer confidence supported by rising house prices and falling levels of unemployment. UK GDP rose by 0.8% in the third quarter, making it the best quarterly figure since mid-2010, with the construction sector posting the strongest growth. We expect this trend to continue into 2014 driven by the government's initiatives to boost lending, such as the "Funding for Lending" and "Help to Buy" schemes, improving consumer confidence and continued loose monetary policy. Despite the improved outlook, we believe the Bank of England is unlikely to raise interest rates in 2014. One of the main risks to the recovery remains the timing of the withdrawal of stimulus measures in the US and the potential implications this could have on economic growth.

US

The rally in US stocks following the Fed's decision not to taper its bond buying programme was relatively short lived as Congress was unable to agree on a new budget, which led to the first government shutdown in 17 years. Although an 11th hour deal was struck to increase the debt ceiling, this has only really postponed negotiations into early 2014. Estimates suggest the shutdown has taken $24 billion out of the economy and could shave as much as 0.9% off GDP this quarter. Any impact on economic growth is likely to push back the Fed's decision to start tapering asset purchases, which is now not anticipated to commence before the New Year. In addition, it is unlikely we will see a policy change until the new Chair of the Federal Reserve, Janet Yellen, takes office in January when Ben Bernanke steps down. However, the S&P has once again reached record highs following the end of the shutdown on strengthening economic data including improvements in housing market and falling unemployment. The timing of tapering and renewed budgetary negotiations are likely to create some uncertainty as we enter the New Year.

Europe

The significant headwinds faced across Europe over the past few years look to be easing as the eurozone has now exited recession. Economic data show support for a modest recovery, with industrial output growing at its fastest rate for more than two years, although the macro environment appears to improving, growth is still sub-par relative to other developed economies and the ECB has not ruled out the prospect of more stimulus. With reduced political risk and an improved economic outlook, investor optimism towards the region is growing. Equity PE valuations in Europe look attractive on a relative basis compared to other developed markets, particularly in the small and mid-cap sectors, and investors are now looking to benefit from the opportunity to invest in high quality companies at current levels.

Japan

Nearly at the end of a very successful first year in office, the Japanese Prime Minister Shinzo Abe is set to continue his plan to stimulate the economy, with the support of the Japanese central bank. Over the last week, we've seen a return of 5.25% on the Nikkei 225 Index; over 2 weeks 9%, and the Yen back above 100 versus the dollar. It appears that the economic stimulus is having the desired effect in the short term.

Wages, a key aspect of 'Abenomics', continued to increase in September thanks to a rise in overtime and bonuses and, although regular wages still fell from a year ago, the rate of all declined further. Housing starts and construction orders rose strongly, impacted by a rush of orders ahead of the consumption tax rise. Whether Abe's "third arrow" of increasing productivity through structural reform is effective only time will tell.

Asia

In Asia, particularly in China, there is still huge potential for investors, however the country as a whole needs to face up to a number of challenges, such as wasteful investment, particularly at local government level, an overvalued currency and over leveraged corporate balance sheets. In addition, overcapacity has been built up in some low value added industrial sectors (such as steel) as a result of low interest rates and loose monetary policy. The banking sector – which financed these investments – needs better regulation to ensure stability for the financial system. China is entering a period of reform which is potentially very good news if executed well, for it will mean more efficient allocation of resources and a more robust financial system. However, reform is seldom without pain, but signs are there that these factors are being taken seriously as shown recently by the relaxation of the 40 year old 'One Child' policy. There will always be casualties in any reform process, as well as emerging winners which will give rise to investment opportunities. There are many things which can be done better in China, and good companies have lots of room to add value and make good returns in the process.

Global Emerging Markets

The International Monetary Fund's half yearly outlook paper, downgraded global economic growth from 3.2% to 2.9% in 2013 and from 3.8% to 3.6% in 2014. Reductions to forecasts for Russia, Mexico and India were the key reason for the downgrade, while the UK was the only upgraded country. The report echoed the view that going forward we could see developed economies slowly strengthening and developing economies slowly decelerating in an environment of subdued inflation. However, the longer term benefits of faster economic growth (than the developed world) and improving population demographics cannot be ignored, and it is for these reasons we remain positive on the longer term story for Emerging Markets. There are short term headwinds in Emerging Markets, but these are times when potential risks are balanced out by opportunities for finding good undervalued businesses offering real long term growth prospects.

Commodities

Q3 witnessed a significant recovery in resource equities with cyclical sectors strongly outperforming defensive sectors. The MSCI Materials was the best performing sub-sector, although it is still lagging year-to-date. From a fundamentals perspective, we have begun to see early signs of improvement, notably in the mining sector however valuations still remain near multi-year lows. Investors continue to keep a close eye on the impact Chinese growth has on commodity consumption. Meanwhile, base metal prices stand to benefit from increased demand from developed economies, which account for around 60% of global metal demand. The gold price experienced its biggest drop in three decades earlier this year, but has been supported by Asian physical buyers over the past few months. There is much to be positive about in the outlook for companies listed in the commodities sector. The sector is currently significantly under-owned and attractively valued; offering longer term investors significant investment opportunities.

Fixed Interest

The prospect of tapering has overshadowed bond markets since the initial announcement back in May, with stock markets rallying following the Fed's decision in September to defer this course of action. Yields on US and UK government bonds fell back from their year to date highs, providing a short reprieve, but yields are expected to rise again as the prospect of tapering moves closer. Shrinking yield premiums (spreads) of corporate bonds over safer government bonds and an uncertain fiscal and monetary policy outlook in the US means finding value in the fixed income markets is more challenging and, as such, we see better relative opportunities in equities than fixed interest at this time.