Parallel
Investment Management

Market Commentary February 2014

Developed equity markets appreciated substantially during 2013, led by a sustained economic recovery in the US, improving conditions in the eurozone and positive sentiment towards Japan. However, developing markets did not enjoy such good fortunes as concerns surrounding the potential impact of US tapering and slowing growth triggered uncertainty among investors. The US Federal Reserve (Fed) finally confirmed its plans to taper its monetary stimulus program in December by reducing monthly asset purchases by $10bn to $75bn. The expectation is for purchases to be cut in $10bn monthly steps, which continued on schedule in January. The reaction of global financial markets to these actions has generally been encouraging, having less of an impact than during the summer, as the Fed's approach seems to be in line with market expectations. The outlook for developed market equities remain underpinned by the prospect of sustained economic growth, however after a strong rise in 2013 we should expect a more moderate pace of returns in 2014. Valuations are now reasonable as opposed to cheap and companies must now deliver on the relatively high earnings expectations that have become embedded in share prices. In developing markets, we expect volatile conditions to remain given the challenges they face, however we remain confident in the long term outlook for these markets which have the potential to reward patient investors.

UK

The UK appears to be in a relatively strong position with the economic recovery looking sustainable and growth forecasts for 2014 having been revised up. Consumer confidence is returning as the job market improves and discretionary spending looks encouraging, receiving a boost from huge PPI payments that have quickly found their way into expenditure, especially vehicle sales. The unemployment rate has fallen faster than anticipated, leading to a revision in the Bank of England's forward guidance policy to include a range of different indicators, not just employment figures. Inflation has finally fallen below the BoE's 2% target for the first time in four years, easing pressure on the BoE to raise rates, whilst a slight slowing of economic growth in Q4 has underlined this message. 2013 was a strong year for UK equity returns across the entire market cap spectrum. We believe UK stocks still exhibit reasonable value and that they can continue to make progress as the recovery strengthens. At a company level, corporates are in a strong financial position, confidence is increasing and dividend growth remains robust.

US

The US economy made substantial progress in 2013, supported by low inflation, robust corporate balance sheets and a strengthening manufacturing sector. As a result, US equity markets enjoyed a buoyant year, with the S&P 500 index returning 32%, its strongest year since 1997. The US economic recovery has gained sufficient momentum for the Fed to announce a reduction in the amount of monetary stimulus it injects into the financial system, which many economists expect to be withdrawn by the end of 2014. However the Fed has been keen to stress that it expects to keep interest rates low until well after the unemployment rate declines below 6.5%. After a strong run in 2013, US equities are now trading in line with or slightly above their historical averages. We expect corporate fundamentals to remain robust and profitability to remain strong which should enable US stocks to make further progress throughout 2014. However potential revenue disappointments and earnings shortfalls are risks to this scenario.

Europe

The eurozone economy grew by 0.3% in the final quarter of 2013 and has now expanded for three quarters in a row since the end of an 18-month recession. Germany has been the driver of this, with a modest return to growth in Italy and Spain, however growth remains uneven by country. One area that has become a concern is France, where manufacturing data has fallen significantly and President Hollande's aggressive tax agenda is discouraging private enterprise and investment. Whilst the growth figures are encouraging, economic activity is still well below its pre-crisis peak and inflationary pressures are likely to remain weak. As such, we could see further stimulus measures from the ECB to combat this. The recovery has also not proved robust enough to make much of an impact on the unemployment rate, which is expected to stay around the 12% level for much of this year. The outlook for European equities in the medium term remains attractive, however in the short term there needs to be evidence of sustained earnings growth. Although equities are not as cheap as they were given last year's appreciation, there are still plenty of opportunities for a stock picking approach.

Japan

The Japanese stock market delivered exceptional returns in 2013 as the effects of Abenomics started to feed through to the underlying economy. The policies being employed by the BoJ mark a seismic shift both economically and in the Japanese mindset, where persistent deflation, very low wage growth and high savings rate have been the norm. The yen has depreciated significantly against the dollar, reaching a five year low in December, which has helped to boost exports and increase corporate profits. Wage growth will be a critical factor for the economy this year to help offset the consumption tax hike that comes into effect in April. The transformation of the Japanese economy is still at a relatively early stage and it is important to remain realistic about the prospects of a sudden transition. The structural reforms that make up the 'third arrow' of Abenomics will take time to implement, but nevertheless we are positive on the long term potential for the world's third largest economy. Despite a strong year last year we believe there are still opportunities within the Japanese market. We are particularly positive on the potential for domestic equity investment to drive Japanese markets higher, with schemes such as a Japanese ISA being introduced to boost share ownership and institutional investors being encouraged to raise their allocations to Japanese equities from current low levels.

Asia

Although Asian equity markets delivered a modest positive return in 2013, they underperformed developed equity markets by some margin. This trend has continued into the start of 2014 as markets react to tapering by the Federal Reserve and weaker economic data. In China, GDP growth fell slightly to 7.7% year-on-year in Q4 and weaker than expected manufacturing data surprised markets providing a catalyst for a sell-off. Reform in China remains top of the agenda for authorities with the country repositioning itself away from investment towards consumption. Whilst a slowdown in China is now generally accepted, the debate is over the pace of decline and any surprises to growth expectations are likely to result in increased levels of volatility. In the short term, Asian markets are likely to be dominated again this year by monetary policy developments in the US and developments in China. However, the favourable demographics, continued infrastructure investment and an unfolding domestic consumer story mean the region still remains the engine for long term global growth.

Global Emerging Markets

Emerging markets also endured a difficult 2013, significantly underperforming developed equity markets. Concerns over Fed tapering, a slowdown in China, improving sentiment towards developed equities and increasing challenges to economic growth in other emerging economies have prompted outflows of capital from these markets. Furthermore, losses have been compounded by the depreciation of many emerging market currencies. As a consequence, we have seen a number of interest rate rises to stem these outflows. The performance of emerging market equities in 2014 will likely continue to be influenced by developments across the broader global economy. While uncertainties lie ahead, a lot of negativity has been priced in and emerging market valuations are undemanding at current levels. That said, the challenges facing emerging markets are not over yet and we could see some further currency weakness. As such, we are cautious in our outlook in the near term, but acknowledge that volatility presents good opportunities for stock pickers.

Fixed Interest

Uncertainty surrounding Fed tapering and expectations of interest rate rises dominated global markets in 2013. UK gilts delivered negative real returns for the year, whilst investment grade corporate bonds performed only marginally better. Emerging market bonds were particularly adversely affected as concerns over the withdrawal of liquidity caused significant risk-off sentiment among investors. High yield bonds were the stand out performers, supported by strong issuer fundamentals and low default rates. The road to monetary policy normalisation has now begun and bond markets will continue to pay close attention to the actions of the Fed for the foreseeable future. Given inflationary pressures remain low, central banks will be loath to risk choking off the recovery by raising rates too soon, with 2015 still appearing to be a realistic target for some rate rises. Demand for fixed interest should be supported by strong corporate fundamentals and the ongoing hunt for yield by investors. We continue to see better value in high yield bonds over government and investment grade bonds, although acknowledge that even here returns may fall below their long term averages this year.

Commodities

Given global demand dynamics, the outlook for commodity markets in 2014 remains mixed. Whilst growth is improving in developed economies, providing a boost many industrial metals, this is partly being offset by an easing of growth in China. The oil price is being held up by conflict in South Sudan where fighting has led to supply fears for this key producing state. Gold was one of the worst performing asset classes in 2013 as the price of bullion fell for the first time in 13 years. The improving global economy and low inflation saw demand for safe haven assets such as gold diminish. Investors still have very little appetite for commodity assets and this is unlikely to change until we see global growth prospects improve substantially. The strength of the dollar could also put downward pressure on commodity prices and, by extension, some emerging market assets. However a lot of this is priced in to commodity markets and at some point prices could find some sustainability.