Parallel
Investment Management

Market Commentary May 2014

While the MSCI World Index during March was essentially flat in local currency terms (up 0.2%), individual regions had very different trends. In Europe, the "risk-on" trade continued, with Italy (up 6.6%) and Spain (up 2.6%) handsomely outperforming, while the UK (down 2.7%) and Germany (down 1.5%) were both laggards, despite better macro data. Meanwhile, US equities rose 0.6%, as investors focused on the prospects for good first-quarter 2014 earnings. Conversely, Japan modestly underperformed, falling 0.4%, as investors fretted about the looming sales tax hike. Of note, emerging markets outperformed their developed counterparts in March, with the MSCI Emerging Markets Index rising 1.9% in local currency terms. The star performers for the month were Turkey (up 13%), Brazil (up 7%) and India (up 5%). By contrast Russia, Egypt and China all closed the month weaker. The International Monetary Fund's (IMF's) latest growth forecasts are encouraging, with material upward revisions for 2014 economic growth forecasts in Europe. The IMF now expects economic expansion of 1.2% in the Eurozone and a punchy 2.9% in the UK. Overall, the IMF's forecast for global growth of 3.6% seems realistic, and is reflective of a modest global recovery being underway.

UK

Britain's unemployment rate unexpectedly dropped in the three months to February, reviving speculation the Bank of England will start raising interest rates earlier than it has signalled. Wages also caught up with inflation for the first time in nearly four years, helping the government to ward off charges of a cost-of-living crisis before next year's national election. The UK has confounded expectations as growth has accelerated after a prolonged period of stagnation. Service and manufacturing confidence levels point to even stronger growth ahead. However, for this to be sustained consumers and companies need to maintain higher spending levels and the backdrop is rather mixed. The Chancellor has confirmed that long-term austerity remains firmly in place, albeit the squeeze in the first half of 2014 will be less than in recent years. All of the good economic news should not hide the fact that despite the severe spending cuts, both the budget deficit and public debt is higher than projected and the latter will continue to rise. Although, if UK companies can meet analysts expectations deliver strong earnings growth the UK market looks set to provide investors with reasonable long term returns.

US

The US economy lost momentum in the early part of the year partially due to severe weather conditions (the polar vortex) that depressed activity across a wide range of sectors. Instead of the widely predicted 3 - 3.5% growth rate (year on year) the economy is likely to have expanded by just 2% in the first quarter with a slightly better tone expected in the second quarter. However, this failed to deter the Fed, under new Chairperson Janet Yellen, as it pressed ahead with QE tapering and is on schedule to finish this programme by the Autumn. Inadvertently the Fed also managed to spook markets, albeit temporarily, by hinting that under certain conditions interest rates may well go up. The housing market which had been the major driver of growth over the past few years, has slowed down, with a range of forward looking indicators suggesting that at best housing is likely to be only marginally positive for overall growth. In addition to housing, the labour market has also disappointed, with a run of lower than expected employment growth data and the Q2 outlook remains mixed. However, the underlying dynamics suggest that the labour market is not as strong as expected, with part-time employment at record highs, modest real wage growth and with more QE tightening on the horizon this situation will be closely monitored by the Fed with concerns a significant increase in interest rates could prove negative for the economy as a whole.

Europe

Macroeconomic data across the Eurozone continues to shows signs that the economic recovery is gaining traction. Europe seems to be emerging from the gloom, with GDP expected to grow modestly. However, a strong rebound remains a distant dream given the deep rooted problems faced by many of the peripheral economies. There are also far more concrete signs of manufacturing and service sector confidence levels rising across the Eurozone and this should lead to the region growing in 2014, albeit mildly. It is likely that two years of contraction in Spain and Italy may come to an end in 2014. Germany will of course be the leader yet again having bounced back from the slow-down in the early part of the year as industrial production jumped as well as other leading indicators. Inflationary pressures are dissipating fast, with prices actually falling in many peripheral countries and close to zero in many of the core countries. The macro backdrop is also being undermined by the ferocity of the deleveraging by the financial sector. Banking sector assets have already fallen by almost €2.5 trillion, the 2014 AQR (Asset Quality Review) is also hardly likely to lead to an expansion in the banks' balance sheets. As a result, the role of the ECB will yet again be critical. The ECB President, Mario Draghi, has already hinted that the Central Bank is ready to use unconventional measures (QE in various forms) to counter deflation.

Japan

In local currency terms, Japan has fallen 7.5% on a year-to-date basis. This has been driven by a number of factors, including profit-taking after strong performance in 2013, a 2% strengthening of the Japanese yen vs. the US dollar during the first quarter, and investor concerns about the impact on GDP growth of the sales tax hike on 1 April. There is anxiety that, as was the case in 1997, the increase in the sales tax will provoke a negative growth shock. However, the indications are that the Bank of Japan is both well aware of this danger and prepared to use quantitative easing (QE) to safeguard growth. Any new QE measures, meanwhile, are likely to lead to yen depreciation, which historically has been good for Japanese equity returns. Key economic indicators such as land prices in the Tokyo metropolitan area and the Shoko Chukin smaller companies sentiment survey are the strongest they have been in many years. Stocks are still cheap in price-to-earnings and price-to-book valuation terms, and earnings momentum is still relatively strong compared to both European and emerging markets.

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

Despite a great deal of news coverage for emerging markets, particularly Ukraine and Russia, very little has fundamentally changed for the asset class. Emerging markets remain cheap by historical standards, with economic and earnings momentum remaining disappointing. Interest rate rises and some prospects for structural reforms have been rewarded and have soothed investor nerves. Strong demand for emerging market bonds is also positive. This has led to strong year-to-date gains for previously vulnerable markets such as Indonesia, South Africa, India and Turkey. The greatest risk for emerging markets, and possibly the global economy, is a hard landing in China. We believe that an accelerating global growth environment will be beneficial for Chinese exports, as will the recent weakening of the renminbi. The financial sector in China remains a concern for investors given the high level of aggregate borrowing in the economy and the inefficient allocation of credit. It is interesting that emerging markets outperformed developed equities, as measured by the MSCI World Index during March, and that emerging market equity fund flows turned positive in the final week of the month. However, for emerging markets to outperform on a sustained basis, we need to see evidence that emerging market companies can deliver EPS (earnings per share) growth that is demonstrably superior to that of the US.

Fixed Interest

Investment grade and higher yielding corporate bonds performed relatively well over the past quarter helped partially by the rally in US Treasuries but also buoyed by credit spreads narrowing. This latter feature is particularly encouraging as it shows that investors have continued to focus on the intrinsic strength of corporate balance sheets. Primary market issuance was relatively strong. Our overall view remains constructive particularly for cyclical issuers that will benefit from faster global economic growth. Financial bonds have been a major beneficiary from economic recovery and the tougher regulatory environment. Despite the fears of significant outflows, EM hard currency debt and selective local currency debt performed well. We are mindful of taking too much risk in fixed interest allocations and continue to be selective with strategies employed ensuring as much diversification as possible in our fixed interest strategies.

Commodities

Broad commodities have had a tough year again, with certain sectors in a bearish market (industrial metals) and precious metals falling sharply and displaying far greater volatility. Looking ahead, a stronger global economy, lower rates and a rebound in EM in 2014 should be supportive. However, we are also mindful of the dynamics across each sector, looking at factors such as the impact of inventories, demand and supply constraints, which have yet to show the signs of a full recovery and China will have a big part to play in this story.